

PR 2005/56 - Income tax: Arafura Pearl Farms 2005

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 This document has changed over time. This is a consolidated version of the ruling which was published on *20 April 2005*



Product Ruling

Income tax: Arafura Pearl Farms 2005

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Potential participants may wish to refer to the Tax Office website at www.ato.gov.au or contact the Tax Office directly to confirm the currency of this Product Ruling or any other Product Ruling that the Tax Office has issued.

Preamble

*The number, subject heading, **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 Tax Office **does not** sanction or guarantee this product. 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 participants 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 and how the product fits an existing portfolio. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

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

Terms of use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling, this arrangement is referred to as the 'Arafura Pearl Farms 2005' or simply as 'the Project'.

Tax law(s)

2. The tax laws 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;
- section 17-5 of the ITAA 1997;
- Division 27 of the ITAA 1997;
- Division 35 of the ITAA 1997;
- Subdivision 61-J of the ITAA 1997;
- Division 328 of the ITAA 1997;
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL of the ITAA 1936;
- sections 82KZME and 82KZMF of the ITAA 1936; and
- Part IVA of the ITAA 1936.

Goods and Services Tax

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

Changes in the Law

4. Although this Ruling deals with the laws enacted at the time it was issued, later amendments may impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating 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 participants in projects such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is the persons more specifically identified in the Ruling part of this Product Ruling and who enter into the arrangement specified below on or after the date this Ruling is made and on or before 29 April 2005. They will have a purpose of staying in the arrangement until it is completed (that is, 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, each of these persons, referred to as 'Growers', will be wholesale clients for the purpose of the *Corporations Act 2001* or will have accepted an offer which qualifies as a small scale offer for the purpose of the *Corporations Act 2001*.

8. This Ruling does not apply to persons who:

- intend to terminate their involvement in the arrangement prior to its completion;
- do not intend to derive assessable income from the arrangement;
- make the election to collect and market their own pearls; or
- have not been granted a Special Permit under paragraph 17(1)(e) of the *Fisheries Act 1988* (Northern Territory) by 16 May 2005.

Qualifications

9. The Commissioner rules on the precise arrangement identified 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. The Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 20 April 2005, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

12. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not commenced and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2007. 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 arrangement specified below. 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

14. The arrangement that is the subject of this Ruling is specified below. This arrangement incorporates the following documents:

- Application for a Product Ruling dated 23 December 2004 as constituted by documents provided on 7 January 2005, 9 February, and additional correspondence dated 27 January 2005, 6 February 2005, 18 February 2005, 27 February 2005, 10 March 2005, 14 March 2005, 24 March 2005 and 29 March 2005;
- Draft **Information Memorandum** received 8 April 2005;
- Draft **Access and Management Agreement** between Arafura Pearls Pty Ltd ('the Manager') and the Grower, received 23 March 2005;
- Site Agreement granting Arafura Pearls Pty Ltd the use of the Elizabeth Bay site for Pearling Operations dated 11 September 1997;
- Agreement between Arafura Pearls Pty Ltd and Arafura Pearls Holdings Pty Ltd for the use of infrastructure received on 24 March 2005; and
- Draft of Special Permit to be issued for each Grower under paragraph 17(1)(e) of the *Fisheries Act 1988* (Northern Territory).

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

15. The documents highlighted are those that Growers may enter into. 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, which are a part of the arrangement. The effect of these agreements is summarised as follows.

16. In accordance with the above documents, a Grower who participates in the arrangement must be a wholesale client or have accepted an offer that is a small scale offering. **This Ruling does not apply unless:**

- the Grower is a wholesale client as defined in section 761G of the *Corporations Act 2001*; or
- not being a retail client, the Grower has accepted a 'personal offer' of a small scale offering for the purpose of the *Corporations Act 2001*.

17. Each of these categories is explained in paragraphs 79 to 85 in the Explanation area of this Product Ruling.

18. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of these agreements is summarised as follows.

Overview

19. The salient features of the Arafura Pearl Farms 2005 Project are as follows:

Location	Elizabeth Bay, Northern Territory
Type of business to be carried on by each participant	Pearl Farming
Minimum Interest	1,350 Oysters
Additional Interest	135 Oysters
Term of the Project	6 years
Initial cost per Interest	\$77,000 (includes an amount for prepaid fees)
Ongoing costs	<ul style="list-style-type: none"> • Deferred Management and Access Fees; • Marketing and Sales Costs; • Manager's Bonus; and • Insurance Premiums.

20. The Manager for the Arafura Pearl Farms 2005 Project is Arafura Pearls Pty Ltd. Arafura Pearls Pty Ltd proposes to offer 20 Minimum Interests in the Project via an Information Memorandum. The Manager may accept oversubscriptions subject to the availability of Oysters and Oyster Culture/Fishery Licence Units. There is no minimum subscription. The term of the Project will be for a period of approximately six years.

21. The Project is to be conducted at Elizabeth Bay in the Northern Territory (the site). The Manager currently operates a Pearl Farm on the site. The Project will be run in conjunction with the existing Pearl Farm. The Land Bases and Sea Areas used by the Pearl Farm are granted under a joint Site Agreement.

22. Growers entering into the Project will participate in the aquaculture industry as Growers of Oysters for the production and sale of South Sea Pearls.

23. Each Grower will enter into an Access and Management Agreement with the Manager. Under the terms of the Access and Management Agreement, the Grower appoints the Manager to provide access and services necessary for the cultivation, production and harvesting of Pearls.

24. The Manager holds the necessary Fishery Licences which authorise the entity to engage in the aquaculture of South Seas Pearl Oysters on the Elizabeth Bay site.

25. Arafura Pearls Holdings Pty Ltd owns all the infrastructure required to operate the Pearl Farm. Under an Agreement with Arafura Pearls Holdings Pty Ltd, the Manager has the authority to use all the infrastructure required to provide the services under the Access and Management Agreement to the Grower from the Commencement Date of the Project.

Fisheries Act

26. In accordance with the Northern Territory's *Fisheries Act 1988*, the Manager holds a Northern Territory Pearl Oyster Fishery Licence and a Pearl Oyster Culture Licence ('the Licences') which allow the Manager to aquaculture pearl oysters on the site. In addition the Manager holds 20 Permanent Oyster Culture/Fishery Licence Units and 20 Temporary Oyster Culture/Fishery Licence Units. The Manager can complete 1,000 first seeding operations for every Licence Unit held during the licencing year.

27. The Project will proceed on the basis that all Growers who enter into the Access and Management Agreement with Arafura Pearls Pty Ltd will be granted a Special Permit under paragraph 17(1)(e) of the *Fisheries Act 1988* by 16 May 2005. The Special Permit allows the Grower to do such things under the terms and conditions of the Access and Management Agreement which would otherwise be unlawful without the Special Permit.

28. The Special Permit:

- expires on the Completion Date specified in the Access and Management Agreement;
- does not apply to persons who have ceased to be a 'Grower' under the Access and Management Agreement;
- expires if Arafura Pearls Pty Ltd Pearl Oyster Licences are cancelled or not renewed;
- does not expire if the Licences are transferred and the operation of the Access and Management Agreement will continue in the same manner as the arrangement with Arafura Pearls Pty Ltd; and
- is suspended if at any time the Licences are suspended.

29. The Special Permit will impose the following conditions:

- a Grower shall only engage in aquaculture in accordance with the conditions specified in the Licences;
- a Grower will only engage in pearl aquaculture in accordance with the terms and conditions of the Access and Management Agreement;
- a Grower shall lodge an executed copy of the Access and Management Agreement with the Director of Fisheries;
- a Grower shall not vary the terms of the Access and Management Agreement without the approval of the Director of Fisheries; and
- a Grower shall cause the Manager to notify the Director of Fisheries if the Access and Management Agreement is terminated.

Site Agreement

30. The Manager is a party to a joint site agreement for the lease of Land Bases and the grant of a licence to use specific Sea Areas at the Elizabeth Bay site for the purpose of carrying on Pearling Operations. The Site Agreement currently expires on 3 September 2018.

Sub-Contract Arrangement

31. From the Commencement Date of the Project, Arafura Pearls Holdings Pty Ltd agrees to grant to the Manager full and unfettered access to use its infrastructure, including panels, and plant and equipment to provide services to the Growers under the Access and Management Agreement.

Access and Management Agreement

32. Under the Access and Management Agreement, the Manager agrees to provide access and services to the Grower for the purpose of cultivating and producing South Sea Pearls on the Grower's Pearl Farm. The Grower's Pearl Farm is defined as 'the Oysters, the Panels and that part of the Project Area that the Grower has the right to use and access for the purpose of cultivating Pearls under this Agreement'.

33. The Commencement Date of the Access and Management Agreement is 29 April 2005. The Completion Date is the earlier of, the date of payment of the final distribution or proceeds from the final harvest, or 31 December 2011.

34. The Grower will be allocated 1350 Spat (juvenile hatchery-reared oysters) per Minimum Interest, and 135 Spat per Additional Interests at the Commencement Date. The Grower's Interest will be located on Panels, which will be identified by a reference number. The Grower has the right to access the Pearl Farm and utilise the Oysters and Panels for the purpose of cultivating, producing and harvesting Pearls.

35. Within 18 months of the Commencement Date, the Manager will replace any dead Spat with live Spat to ensure the Grower has at least 1,300 Spat for each Minimum Interest and 130 Spat for each Additional Interest.

Access and Management Services

36. Under the Access and Management Agreement, the Manager grants to the Grower the right to access the Pearl Farm in consideration for the payment of Access Fees.

37. The Grower appoints the Manager to supervise and manage all commercial pearlting activities on the Grower's Pearl Farm and to perform the Services listed in the Schedule.

38. Clause 4.1 of the Access and Management Agreement states that the Manager will provide the Grower with exclusive access to the Panels which hold the Grower's Oysters and to clearly identify those Panels as those of the Grower. At the expiration or termination of the Project the Grower must yield up all surviving and dead Oysters, and the Panels over which they had exclusive use.

39. During the Initial Management Period, from 29 April 2005 to 30 June 2005, the Manager will provide Initial Management Services including:

- the right to utilise the benefit of the annual Quota;
- monitor Spat growth rates and health to determine the timing of selection and grading;
- transport Spat held on collectors on Long Lines from the ocean to the land based hatchery;
- establish selection criteria and supervise grading process;
- select, grade and clean the Spat;
- place the Spat and the Oysters in 48 pocket Panels;
- transport the Spat from the land based hatchery for placement on the Long Line System;
- establish and maintain management records and a specialised data base in respect of the Spat and the Oysters; and

- operate and maintain all land based equipment necessary for the operation of the Grower's Pearl Farm.

40. From 1 July 2005 until the Completion Date, the Manager will provide Ongoing Management and Access Services, including:

- the right to utilise the benefit of the annual Quota;
- establish a marketing plan to enable the orderly marketing of the Pearls;
- transfer Spat and Oysters into 15 and 8 pocket Panels;
- maintain management records in respect of the Spat and the Oysters;
- operate cleaning teams and cleaning vessels to assist with maintaining the Spat and the Oysters;
- clean the Spat and the Oysters by hand and by machine;
- assist with stock taking of the Spat and the Oysters;
- clean, maintain and position the Long Line System;
- clean and maintain the nets and the Panels;
- attend to pre-seeding routines, seeding and post seeding routines including turning and x-raying;
- attend to Harvest of the Pearls;
- attend to the marketing of the Pearls;
- maintain records of production results;
- provide management reports to the Grower on an annual basis; and
- access for the Grower to the Pearl Farm.

Seeding

41. The seeding of the Oysters will take place on three occasions over the term of the Project:

- the First Seeding Operation when the Oysters are two years old;
- the seeding of Vomit Oysters within 12 months of the First Seeding Operation; and
- the Second Seeding Operation of those Oysters which were harvested and produced a commercially saleable pearl, at approximately four years.

42. When seeding the Manager must comply with the Oyster Quota which allows the Manager to seed 1000 Oysters per Minimum Interest held by the Grower per year, plus 100 Oysters per Additional Interest.

43. If the number of Oysters available to be seeded at the First Seeding Operation for all Growers in the Project exceeds the Quota limit, then the Manager must, in order to comply with the Quota limit, reduce the number of Oysters to be seeded on behalf of each Grower on a pro rata basis (Clause 17.3).

Harvesting and Sale

44. The Manager will harvest the Pearls on three separate occasions during the Term (clause 17.4). The Manager shall determine the times to harvest the Pearls in accordance with Good Industry Practice.

45. The Grower's Pearls will be pooled with the Pearls of other Growers who do not choose to market and sell their own Pearls (Non-Electing Growers). The Manager is appointed as the agent for marketing and selling of the Non-Electing Growers' Pearls.

46. The Grower's Harvest Interest is the number of Pearls that are produced and harvested from the Grower's Pearl Farm. The Grower's Proportional Interest in the Gross Pearl Sales is the proportion of the Grower's Harvest Interest bears to the Non-Electing Interest. The 'Non-Electing Interest' means the aggregate of the number of Pearls produced and harvested on behalf of the Non-Electing Growers.

Fees

47. In consideration for the services performed and the rights granted under the terms of the Access and Management Agreement, the following fees will be payable by the Grower:

- the Subscription Sum;
- Marketing and Selling Fees;
- Deferred Management and Access Fees;
- the Manager's Bonus; and
- Insurance Premiums.

Subscription Sum

48. The Subscription Sum of \$77,000 per Minimum Interest is payable by the Grower to the Manager pursuant to the Information Memorandum, on or before 29 May 2005. This amount is consideration for Access and Management Services in the following years:

Fees	2004-05 Year 0	2005-06 Year 1	2006-07 Year 2
Access Fee	\$55	\$660	\$660
Management Fee	\$60,445	\$4,840	\$10,340
Total	\$60,500	\$5,500	\$11,000

49. An additional amount of \$7,700 is payable for each Additional Interest for Access and Management Services as follows:

Fee	2004-05 Year 0	2005-06 Year 1	2006-07 Year 2
Access Fee	\$5.50	\$66	\$66
Management Fee	\$6,044.50	\$484	\$1,034
Total	\$6,500	\$550	\$1,100

Deferred Management and Access Fees

50. Deferred Management and Access Fees are payable in consideration for the Manager performing Ongoing Management and Access Services in Years 1 to 6. This is additional to the prepaid amounts for Years 1 and 2, included in the Subscription Sum. The Deferred Management and Access Fee is 31% of Net Pearl Sales and is payable at the conclusion of each Harvest (clause 18). 'Gross Pearl Sales' means the gross amount received by the Manager from the sale of the Non-Electing Growers' Pearls. 'Net Pearl Sales' is the Gross Pearl Sales less the costs reasonably incurred by the Manager to market and sell the Non-Electing Growers' Pearls.

51. At the conclusion of the Project, the Grower will be obliged to pay the Deferred Management and Access Fee Shortfall. The Deferred Management and Access Fee Shortfall will be the difference between the Deferred Access and Management Fees paid from Net Pearl Sales and the following Target Levels:

Income Year	Target Levels per Minimum Interest	Target Levels per Additional Interest
2006-07 (Year 3)	\$10,300	\$1,030
2007-08 (Year 4)	\$16,800	\$1,680
2008-09 (Year 5)	\$7,100	\$710
2009-10 (Year 6)	\$7,700	\$770
Total	\$41,900	\$4,190

52. The Target Levels include an amount for Access Fees of \$660 per year for a Minimum Interest and \$66 per year for an Additional Interest. If, at the conclusion of the Project, there is a Deferred Management and Access Fee Shortfall, the Manager will invoice the Grower for the amount of the Shortfall.

Marketing and selling costs

53. The Grower's Proportional Interest in the Gross Pearl Sales will be reduced by their share of the costs the Manager reasonably incurs to market and sell the Non-Electing Growers' Pearls.

Manager's Bonus

54. The Manager will be entitled to a Manager's Bonus equal to 50% of the total net return payable to each Grower where the internal rate of return exceeds 15% for each Interest (Clause 19).

Insurance Premiums

55. The Manager will seek to arrange insurance against the destruction or damage of the Oysters by cyclone or environmental pollution, on behalf of the Grower, if requested to do so. The Grower will bear the costs of any such insurance.

Finance

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

57. This Ruling does not apply if the finance arrangement entered into by the Grower includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL of the ITAA 1936 or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;

- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project are involved or become involved in the provision of finance to Growers for the Project.

Ruling

Application of this Ruling

58. This Ruling only applies to Growers who:

- are accepted to participate in the Project on or before 29 April 2005;
- have executed an Access and Management Agreement by that date;
- are either a wholesale client (section 761G of the *Corporations Act 2001*) or have accepted a 'personal offer' of a small scale offering (section 1012E of the *Corporations Act 2001*); and
- have been granted a Special Permit under paragraph 17(1)(e) of the *Fisheries Act 1988* by 16 May 2005.

The Grower's participation in the Project must constitute the carrying on of a business of primary production.

59. This Ruling does not apply to Growers who make the election to collect, market and sell their own Pearls.

The Simplified Tax System ('STS')

Division 328

60. To be an 'STS taxpayer' a Grower must be eligible to be an 'STS taxpayer' and must have elected to be an 'STS taxpayer'. For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different under the STS where the Grower uses the cash accounting method.

Qualification

61. This Product Ruling assumes that a Grower who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Grower may become an 'STS taxpayer' at a later point in time. In addition, a Grower who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer', during the term of the Project. These are contingencies relating to the circumstances of individual Growers that cannot be accommodated in this Ruling. Such Growers can ask for a private ruling on how the taxation legislation applies to them.

25% Entrepreneurs tax offset***Subdivision 61-J***

62. For the first income year starting on or after 1 July 2005, Subdivision 61-J of the ITAA 1997 provides a 25% tax offset of income tax liability related to the business income of a business in the STS with annual group turnover of less than \$75,000. Entitlement to the offset varies depending on the type of entity and is therefore outside the scope of this Ruling.

Assessable income***Section 6-5***

63. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

64. Other than Growers referred to in paragraph 65, for the 2005-06 income year and later years, a Grower will be assessable on ordinary income from carrying on their business of pearl farming in the income year in which that income is derived.

65. For the 2005-06 income year and later years, a Grower who is an 'STS taxpayer' using the cash accounting method will be assessable on ordinary income from carrying on their business of pearl farming in the income year in which that income is received.

Trading stock***Sections 70-35 and 70-45***

66. During the term of the Project, a Grower may hold harvested Pearls that will constitute trading stock on hand. Section 70-35 requires the Grower to include the value of the trading stock in working out assessable income and deductions.

67. Where, in an income year, the value of trading stock on hand at the *end* of an income year exceeds the value of trading stock on hand at the *start* of an income year a Grower must include the amount of that excess in assessable income.

68. Alternatively, where the value of trading stock on hand at the start of an income year exceeds the value of trading stock on hand at the end of an income year, a Grower may claim the amount of that excess as an allowable deduction.

69. Under section 70-45, the Grower can elect to value trading stock on hand at the end of the income year at cost, market selling value or replacement value. Where the Grower elects to value the trading stock at the end of the income year at cost, 'cost' would include only those expenses incurred until the Pearls became trading stock of the Grower.

70. During the term of the Project, the Manager will provide sufficient information to enable the Grower to determine the value of the trading stock on hand at the end of the relevant income year.

Section 328-285

71. Section 70-35 requires the Grower to include the value of the trading stock in working out assessable income and deductions, unless the Grower who is an 'STS taxpayer' is able to choose not to apply this section as the conditions in subsection 328-285(1) are met.

72. Subsection 328-285(1) provides if the difference between the value of all the Grower's trading stock at the start of an income year and a reasonable estimate of the trading stock at the end of the income year is less than \$5,000, an 'STS taxpayer' does not have to account for that difference under the ordinary trading stock rules in sections 70-35 and 70-45. The value of all the trading stock on hand at the end of the year will instead be considered equal to the trading stock on hand at the start of the year.

Deductions for Access Fee, Management Fees and Insurance Premiums

Section 8-1

73. A Grower may claim tax deductions under section 8-1 of the ITAA 1997, for the revenue expenses in the Tables below.

74. However, if for any reason, an amount shown or referred to in the Tables below is not fully paid in the year in which it is incurred by a Grower who is an 'STS taxpayer' using the cash accounting method, then the amount is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount shown in the Table(s) below which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid.

75. Deductions available for a Grower with the Minimum Interest, are as follows:

Fee Type	Year ended 30 June 2005	Year ended 30 June 2006	Year ended 30 June 2007
Management Fees	\$60,445 See Notes (i) & (ii)	\$7,590 See Notes (i) & (ii)	\$7,590 See Notes (i) & (ii)
Access Fees	\$55 See Notes (i) & (ii)	\$660 See Notes (i) & (ii)	\$660 See Notes (i) & (ii)
Insurance premiums	As incurred See Notes (i), (iv) and (v)	As incurred See Notes (i), (iv) and (v)	As incurred See Notes (i), (iv) and (v)

Deductions available for each Additional Interest held by a Grower, are as follows:

Fee Type	Year ended 30 June 2005	Year ended 30 June 2006	Year ended 30 June 2007
Management Fees	\$6,044.50 See Notes (i) & (iii)	\$759 See Notes (i) & (iii)	\$759 See Notes (i) & (iii)
Access Fees	\$5.50 See Notes (i) & (iii)	\$66 See Notes (i) & (iii)	\$66 See Notes (i) & (iii)
Insurance premiums	As incurred See Notes (i), (iv) and (v)	As incurred. See Notes (i), (iv) and (v)	As incurred. See Notes (i), (iv) and (v)

Notes:

- (i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (for example, input tax credits): Division 27. See Example 1 at paragraph 119.
- (ii) The Subscription Sum of \$77,000 for a Minimum Interest consists of an Initial Management and Access Fees totalling \$60,500 and a prepayment of the Management and Access Fees for the income years ending 30 June 2006 and 2007 totalling \$16,500. The Subscription Sum must be paid by 29 May 2005. The Initial Management and Access Fees of \$60,500 are for access and services to be provided in the Initial Management Period and are deductible in the income year ending 30 June 2005.

However, the amount of \$16,500 prepaid in respect of the Ongoing Management and Access Services is **NOT** deductible in the year in which it is incurred. Deductions for this amount **must** be determined using the formula in subsection 82KZMF(1) (see paragraphs 104 to 112). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser. The 'eligible service period' commences on 1 July 2005 and ends on 30 June 2007. Accordingly, an amount of \$8,250 is deductible in each of the years ended 30 June 2006 and 30 June 2007.

- (iii) The Subscription Sum of \$7,700 for each Additional Interest consists of Initial Management and Access Fees totalling \$6,500 and a prepayment of the Management and Access Fees for the income years ending 30 June 2006 and 2007 totalling \$1,650. The Subscription Sum must be paid by 29 May 2005. The Initial Management and Access Fees of \$6,500 are for access and services to be provided in the Initial Management Period and are deductible in the income year ending 30 June 2005.

However, the amount of \$1,650 prepaid in respect of the Ongoing Management and Access Services is **NOT** deductible in the year in which it is incurred. Deductions for this amount **must** be determined using the formula in subsection 82KZMF(1) (see paragraphs 104 to 112). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser. The 'eligible service period' commences on 1 July 2005 and ends on 30 June 2007. Accordingly, an amount of \$825 is deductible in each of the years ended 30 June 2006 and 30 June 2007.

- (iv) For the 2005-06 income year and later years, where a Grower pays the Insurance Premiums in accordance with the Access and Management Agreement, those fees are deductible in full in the year that they are incurred where the Grower is not an 'STS taxpayer' or, is an 'STS taxpayer' using the accruals accounting method.
- (v) For the 2005-06 income year and later years, where a Grower pays the Insurance Premiums in accordance with the Access and Management Agreement, those fees are deductible in full in the year that they are paid where the Grower is an 'STS taxpayer' who uses the cash accounting method.

Interest

76. The deductibility or otherwise of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. However all Growers who borrow funds in order to participate in the Project, should read the discussion of the prepayment rules in paragraphs 104 to 110 as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower's choice.

Division 35 – deferral of losses from non-commercial business activities***Section 35-55 – exercise of Commissioner's discretion***

77. A Grower who is an individual accepted into the Project by 29 April 2005 may have losses arising from their participation in the Project that would be deferred to a later income year under section 35-10. Subject to the Project being carried out in the manner described above, the Commissioner will exercise the discretion in paragraph 35-55(1)(b) for these Growers for the income years ending **30 June 2005 to 30 June 2008**. This conditional exercise of the discretion will allow those losses to be offset against the Grower's other assessable income in the income year in which the losses arise.

Sections 82KZME, 82KZMF and 82KL and Part IVA

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

- expenditure by a Grower does not fall within the scope of sections 82KZME and 82KZMF (but see paragraphs 104 to 112);
- 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.

Explanation

Corporations Act 2001

79. For this Ruling to apply, an offer for an interest in the Project must:

- have been made to, and accepted by a Grower, who qualifies as a wholesale client as defined in section 761G of the *Corporations Act 2001*; or
- be an offer which qualifies as a small scale offering as defined in section 1012E of the *Corporations Act 2001*.

Small scale offers and offers to wholesale clients do not require a prospectus or product disclosure statement.

80. A Grower in the Project may be a person who is a wholesale client within the definition in section 761G. A person will be a wholesale client where the person satisfies one of the following tests:

- the 'product value test' (paragraph 761G(7)(a));
- the 'individual wealth test' (paragraph 761G(7)(c)); or
- the 'professional investor test' (paragraph 761G(7)(d)).

81. A participant in a managed investment scheme, referred to below as 'the person' or 'the person to whom the offer is made', will satisfy the 'product value test' where:

- the minimum amount payable for the interests in the project on acceptance of the offer by the person to whom the offer is made is at least \$500,000; or
- the amount payable for the interests in the project on acceptance by the person to whom the offer is made and the amounts previously paid by the person for interests in the project of the same class that are held by the person add up to at least \$500,000.

82. A participant in a managed investment scheme, referred to below as 'the person' or 'the person to whom the offer is made', will satisfy the 'individual wealth test' where, it appears from a certificate given by a qualified accountant no more than 6 months before the offer is made, that the person to whom the offer is made:

- has net assets of at least \$2.5 million; or
- has a gross income for each of the last 2 financial years of at least \$250,000 a year.

83. A participant in a managed investment scheme, referred to below as 'the person' or 'the person to whom the offer is made', will satisfy the 'professional investor test' where:

- the person is a financial services licensee; or
- the person controls at least \$10 million for the purposes of investment in securities.

84. Alternatively, under section 1012E, a Grower may participate in the project by accepting a 'personal offer' for an interest in the project. Offers made under section 1012E cannot be accepted by more than 20 investors in any 12 month period and these investors, in aggregate, must not invest more than \$2 million dollars (subsection 1012E(2)).

85. An offer will be a 'personal offer' where it can only be accepted by the person to whom it is made, and it is made to a person who is likely to be interested in the offer because of previous contact, or professional or other connection with the person making the offer, or because they have indicated that they are interested in offers of that kind (subsection 1012E(5)).

Is the Grower carrying on a business?

86. For the amounts set out in the Table above to constitute allowable deductions the Grower's aquaculture activities as a participant in the Arafura Pearl Farms 2005 must amount to the carrying on of a business of primary production.

87. Where there is a business, or a future business, the gross proceeds from the sale of the Pearls 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.

88. For schemes such as that of the Arafura Pearl Farms 2005, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *Commissioner of Taxation v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55.

89. Generally, a Grower will be carrying on a business of aquaculture, and hence primary production, if:

- the Grower has the right to exclusively use the identifiable Panels on which allocated Oysters are cultivated and grown;
- the Grower has a right to harvest and sell the Pearls from those Oysters;
- the aquaculture activities are carried out on the Grower's behalf;
- the aquaculture activities of the Grower are typical of those associated with a Pearl Farming business; and
- the weight and influence of general indicators point to the carrying on of a business.

90. In this Project, each Grower enters into an Access and Management Agreement. Under the Access and Management Agreement each individual Grower will have the right to access the Grower's Pearl Farm and have exclusive use of the Panels on which the Oysters are grown for the Term of the Project. The Panels will be clearly identified as the Panels of the Grower. This right is granted subject to the requirement that the Grower complies with all relevant Licences, laws and regulations relating to the cultivation, production and harvesting of Pearls.

91. The Grower will own the Pearls produced by the Oysters on the Grower's Panels. The Grower has the right to transfer the Oysters or Spat to a new Manager where Arafura Pearls Pty Ltd is removed in accordance with clause 28.2 of the Access and Management Agreement. The transfer to a new Manager must be approved by the Director of Fisheries in accordance with Clause 8 of the Pearl Oyster Culture Industry Management Plan.

92. The Manager is engaged by the Grower to manage and administer the Grower's Pearl Farm. The Manager currently operates a Pearl Oyster Hatchery and Pearl Farm and has provided evidence that it holds the appropriate experience and necessary resources to provide the management services, on the Grower's behalf, to prepare and operate the Grower's Pearl Farm.

93. The Project Manager is also engaged to harvest and sell, on the Grower's behalf, the Pearls produced from the Oysters on the Grower's Panels.

94. 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 Project's description for all the indicators.

95. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Grower in the Project will derive assessable income from the sale of the Pearls that will return a before-tax profit, that is, a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

96. The pooling of Pearls from the Oysters grown on the Grower's Pearl Farm with the Pearls of other Non-Electing Growers is consistent with general aquaculture. Each Grower's Proportionate Interest of the sale proceeds of the pooled Pearls will reflect the proportion of the Pearls contributed from the Grower's Pearl Farm.

97. The Project Manager's services are also consistent with general aquaculture practices. They are of the type ordinarily found in Pearl Farming ventures that would commonly be said to be businesses. While the size of a Grower's Pearl Farm is relatively small, it is of a size and scale to allow it to be commercially viable.

98. The Grower's degree of control over the Manager as evidenced by the Access and Management Agreement, and supplemented by the Corporations Act 2001, is sufficient. During the term of the Project, the Manager will provide the Grower with regular progress reports on the Grower's Pearl Farm and the activities carried out on the Grower's behalf. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect.

99. The aquaculture 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. For the purposes of this Ruling, the Grower's aquaculture activities in the Arafura Pearl Farms 2005 Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

100. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

101. Changes to the STS rules apply from 1 July 2005. The question of whether a Grower is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of Access Fees, Management Fees and Insurance Premiums

Section 8-1

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

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

- where all that happens in a year of income is that a taxpayer is contractually committed 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.

103. The Access Fees, Management Fees and Insurance

Premiums associated with the aquaculture activities will relate to the gaining of income from the Grower's business of Pearl Farming (see above), and hence have a sufficient connection to the operations by which income (from the harvesting and sale of Pearls) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fees appears to be reasonable. There is no capital component of the Management Fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Prepayment provisions

Sections 82KZL to 82KZMF

104. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (for example, the performance of management services or the leasing of land) that will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

105. For this Project, only section 82KZL (an interpretive provision) and sections 82KZME and 82KZMF are relevant. Where the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes them from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

106. Other than expenditure deductible under section 82KZMG, if the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

107. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer's allowable deductions under the agreement for the 'expenditure year' exceed any assessable income attributable to the agreement for that year;
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and
- either:
 - a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

108. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than \$1,000. Such expenditure is immediately deductible.

109. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion relevant prepaid expenditure. Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

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

110. In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Application of the prepayment provisions to this Project

111. The expenditure incurred by a Grower in the Project for the Access and Management Fees meets the requirements of subsections 82KZME(1) and (2) and is incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies, the amount and timing of tax deductions for those fees are determined under section 82KZMF.

112. The prepaid Access and Management Fees incurred by Growers do not fall within any of the 5 exceptions to section 82KZME. Therefore, the deduction for each year is determined using the formula in subsection 82KZMF(1). Section 82KZMF will apportion the deduction for prepaid Access and Management Fees over the period that the services for which the prepayment is made are provided.

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

Section 35-55 – exercise of Commissioner's discretion

113. In deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for the income years ending **30 June 2005 to 30 June 2008** the Commissioner has applied the principles set out in Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses. Accordingly, based on the evidence supplied, the Commissioner has determined that for those income years ended 30 June 2005 up to and including 30 June 2008:

- it is because of its nature the business activity of a Grower will not satisfy one of the four tests in Division 35;
- there is an objective expectation that within a period that is commercially viable for the pearl farming industry, a Grower's business activity will satisfy one of the four tests set out in Division 35 or produce a taxation profit; and
- a Grower who would otherwise be required to defer a loss arising from their participation in the Project under subsection 35-10(2) until a later income year is able to offset that loss against their other assessable income.

114. The exercise of the Commissioner's discretion under paragraph 35-55(1)(b) is conditional on the Project being carried on in the manner described in this Ruling during the income years specified. If the Project is carried out in a materially different way to that described in the Ruling a Grower will need to apply for a private ruling on the application of section 35-55 to those changed circumstances.

Section 82KL – recouped expenditure

115. The operation of section 82KL 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 deduction otherwise allowable under section 8-1.

Part IVA – general tax avoidance provisions

116. 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).

117. The Arafura Pearl Farms 2005 will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 73 to 75 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.

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

Example

Entitlement to GST input tax credits

119. Sarah, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2003, Sarah receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2004 to 30/6/2004	\$4,400*
Carrying out of upgrade of power for your vineyard as quoted	<u>\$2,200*</u>
Total due and payable by 1 January 2004 (includes GST of \$600)	<u>\$6,600</u>

*Taxable supply

Sarah pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

$$1/11 \times \$4,400 = \$400.$$

Hence her outgoing for the management fee is effectively \$4,400 *less* \$400, or \$4,000.

Similarly, Sarah calculates her input tax credit on the connection of electricity as:

$$1/11 \times \$2,200 = \$200.$$

Hence her outgoing for the power upgrade is effectively \$2,200 *less* \$200, or \$2,000.

In preparing her income tax return for the year ended 30 June 2004, Sarah is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as \$4,000 (not \$4,400).

Sarah is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as \$200 (one tenth of \$2,000 only, not one tenth of \$2,200).

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- ITAA 1936 82KZMF(1)

- ITAA 1936 Pt IVA

- ITAA 1936 177A

- ITAA 1936 177C

- ITAA 1936 177D

- ITAA 1936 177D(b)

- ITAA 1997 6-5

- ITAA 1997 8-1

- ITAA 1997 17-5

- ITAA 1997 Div 27

- ITAA 1997 Div 35

- ITAA 1997 35-10

- ITAA 1997 35-10(2)

- ITAA 1997 35-55

- ITAA 1997 35-55(1)(b)

- ITAA 1997 Subdiv 61-J

- ITAA 1997 70-35

- ITAA 1997 70-45

- ITAA 1997 Div 328

- ITAA 1997 328-285

- ITAA 1997 328-285(1)

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- Corporations Act 2001

- Fisheries Act 1988 (NT) 17(1)(e)

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- ITAA 1936 82KL

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