

PR 2001/57 - Income tax: James Estate Vineyard Project

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⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *9 May 2001*



Product Ruling

Income tax: James Estate Vineyard Project

Contents	Para
What this Product Ruling is about	1
Date of effect	11
Withdrawal	13
Arrangement	14
Ruling	42
Explanations	57
Examples	99
Detailed contents list	102

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.

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.

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 James Estate Vineyard Project, or 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 387-165 (ITAA 1997);
 - Division 35 (ITAA 1997);
 - Section 82KL of the *Income Tax Assessment Act 1936* ('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 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.

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 'Growers'.

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. If the arrangements described in the Ruling are materially different from the arrangements that are 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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PR 2001/57

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Date of effect

11. This Ruling applies prospectively from 9 May 2001, 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 begun to be carried out, and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 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

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

- Application for Product Ruling dated 4 April 2001;
- The James Estate Vineyard Project Prospectus dated 5 October 2000, the additional short form prospectus and a draft short form prospectus;

- Constitution for the James Estate Vineyard Project between Cardinal Financial Securities Limited (the ‘Responsible Entity’) and the Grower dated 15 May 2000;
- **Licence and Management Agreement between Cardinal Financial Securities Limited (the ‘Responsible Entity’) and the Grower, undated;**
- Lease Agreement between Cardinal Financial Securities Limited and Sundara Pty Limited (the ‘Land Owner’);
- Vineyard Development and Management Agreement between Cardinal Financial Securities Limited and James Estate Vineyard Management Pty Limited (‘The Management Agreement’), undated;
- Grape Purchase Agreement between each Grower and James Estate Wines Pty Limited, undated; and
- Correspondence received from the Applicant dated 4, 9, 12, 18, 19, 20 and 23 April 2001.

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

15. The document highlighted is that which the Grower enters into or becomes party to. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate (in this ruling ‘associate’ has the meaning as defined in section 318 of the ITAA 1936) of the Grower, will be a party to, which are part of the arrangement to which this Ruling applies, except agreements that come within paragraphs 40 and 41 below, concerning the provision of finance. The effect of these agreements is summarised as follows.

Overview

16. This arrangement is called the James Estate Vineyard Project.

Location	The Upper Hunter Valley Region of NSW approximately 15 kms west of Denman in the Hunter Valley G.I. wine region.
Type of business each participant is carrying on	Commercial viticulture and sale of premium wine grapes for approximately 15 years.

PR 2001/57

Number of hectares under cultivation	250 hectares
Name used to describe the product	James Estate Vineyard Project
Size of each Vineyard Lot	0.25 hectares
Expected production	12.53 tonnes per hectare
Vines planted per hectare	2,222
The term of the investment in years	Approximately 15 years
Initial cost	\$15,400
Initial cost per hectare	\$61,600
Ongoing costs	Annual Management Fees and Rent.

17. Growers applying under the Prospectus enter into a Licence and Management Agreement with Cardinal Financial Securities Limited.

18. Sundara Pty Limited agrees to lease land and the attached water rights to Cardinal Financial Securities Limited (CFSL) who will provide an identifiable licensed area of 0.25 Hectares as each Grower's Licensed area (Vineyard Lot). The Project Land is situated in the Upper Hunter Valley of NSW in the G.I. Region of the Hunter Valley approximately 15 kms west of Denman. The termination of the project is the date of completion of final harvest of the Grape Produce or no later than 30 June 2015.

19. Cardinal Financial Securities Limited will contract with James Estate Vineyard Management Pty Limited to manage, maintain and supervise all viticultural activities on the licensed areas including harvesting and delivery of fruit in accordance with the Grape Purchase Agreement. Cardinal Financial Securities Limited will contract with James Estate Wines Pty Limited to purchase for the term of the project each year's production in accordance with the Grape Purchase Agreement. Cardinal Financial Securities Limited is the Responsible Entity for the project and will manage Grower's interests in the lease, the Licence and Management Agreement and the Grape Purchase Agreement.

20. The short form prospectus and draft short form prospectus state that there is no minimum subscription for the Project. An investor may subscribe for a minimum of one Vineyard Lot with the maximum being full subscription. The Prospectus expires on 30 June 2001.

21. Possible projected returns for Growers are outlined in the short form prospectus and draft short form prospectus under the draft financial projections. The projected returns are subject to the inherent risks of primary production and the commercial risks of a long term venture of growing and harvesting a commercial vineyard and selling

the fruit. The risks associated with the Project have been outlined in the Prospectus. The Viticultural Consultant has stated in the report, at pages 43-50 of the Prospectus that, with appropriate establishment procedures and sound management, this project can achieve its aims and objectives as outlined in the Prospectus.

22. Growers will execute a Power of Attorney enabling the Responsible Entity, Cardinal Financial Securities Limited, to act on their behalf as required when they make an application for a Vineyard Lot.

Constitution

23. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Growers and to manage the Project. The Responsible Entity will keep a register of Growers. Growers are entitled to assign their Grower's Interest in certain circumstances. As stated in paragraph 8 above, this ruling only applies to those Growers who have a purpose of staying in the arrangement for the full term of the Project. Growers are bound by the Constitution by virtue of their participation in the Project.

24. The Responsible Entity will provide a report to Growers as per the Constitution each financial year containing a review of the operations of the Growers' Business during the relevant period.

Compliance Plan

25. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Its purpose is to ensure that the Responsible Entity meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

Interest in Land

26. A Lease is granted by Sundara Pty Limited to Cardinal Financial Securities Limited who will grant licences to the Growers under the terms of the Licence and Management Agreement. Growers are granted an interest in land in the form of a Licence to use their Vineyard Lots for the purpose of cultivating Vines and Harvesting Grapes which they will sell.

27. Growers who are accepted into the Project pay a rent fee of \$1,100 in Year 1. A further amount of \$1,100 is payable on 1 July 2001 for the period 1 August 2001 to 30 June 2002 and \$1,100 is payable on 1 July 2002 which will be indexed by 3%. The term of the Licence is from the Commencement Date until 30 June 2015.

Licence and Management Agreement

28. Each Grower enters into a Licence and Management Agreement with the Responsible Entity. The Licence and Management Agreement will be executed on behalf of a Grower following the Grower signing the Application and a Power of Attorney Form in the Prospectus. Growers are bound by the Licence and Management Agreement by virtue of their participation in the Project. Growers contract with the Responsible Entity to manage, maintain and harvest grapes from the vines and market them on their behalf. Each Grower pays a Management Fee of \$12,100 in Year One and \$1,586 in Year Three and an amount annually thereafter which is the Grower's proportion of the Management Costs (indexed) plus the Corporate Costs for performing the services under the agreement.

29. The Responsible Entity will carry out the following services under the agreement:

- Maintain a trickle irrigation system to the Vines on the relevant Licensed areas;
- Cultivate, tend, prune, fertilise, spray and otherwise care for the vines as and when required;
- Use all reasonable measures to keep the relevant Licensed area free from vermin, noxious weeds, pests and disease;
- At all times maintain the relevant Licensed areas according to good viticultural practice;
- take all reasonable steps to prevent and manage land degradation on the relevant Licensed area and to attend to the maintenance and management of the soil quality on the relevant Licensed area;
- harvest the Vines on the relevant Licensed area and then deliver the Grape Produce to the Purchaser in accordance with good viticultural practice and the Grape Purchase Agreement;
- repair and maintain in a good condition all fences, accessways and other structural improvements including plant and equipment on the farm;
- effect the insurances referred to in the Licence and Management Agreement;
- employ such staff and labour as are necessary for the provision of the services;
- carry out the accounting, financial control and reporting needs and functions of the project;

- keep proper books of account for the project; and
- do all other things that are necessary or incidental to carrying out the Grower's Business to produce a viable business for the growing, marketing and sale of grapes.

30. The Responsible Entity will be responsible for paying the cost of public risk insurance in respect of the Licensed Areas and insurance against destruction or damage from usual risks in accordance with approved industry practices in respect of the grape produce.

31. A Grower can terminate the Licence and Management Agreement where there has been a breach (of a substantial nature) by the Responsible Entity which has not been remedied after written notice by the Grower to do so or where the Responsible Entity commits an act of bankruptcy or goes or is placed into liquidation.

Harvesting

32. The Responsible Entity will be responsible for the harvesting of the grapes and delivery of these grapes to the Purchaser. Commencing from the date of the first commercially harvestable grape crop, or at such time or times as the Responsible Entity in its absolute discretion but in consultation with the purchaser considers appropriate, the Responsible Entity will harvest or arrange for some other person to harvest the Grape Produce. The harvesting will be done at such time or times as, in the opinion of the Responsible Entity, will result in Grape Produce being suitable for the purposes of meeting or exceeding the standards as set out in the Grape Purchase Agreement and therefore achieving the best return for Growers.

33. The Receipts from the sale of Grapes will be paid into the Proceeds Fund established by the Responsible Entity. Receipts received by the Responsible Entity are to be distributed in the following order of priority:

- Payment of any Annual Payments payable by the relevant Grower;
- Payment of any other amounts payable by the relevant Grower under the Licence and Management Agreement or any provision of the Constitution; and
- Distribution of the remainder to the relevant Grower.

Fees

34. The total Fee payable under the Licence and Management Agreement for the Project is \$15,400 per Licensed area. This fee includes the initial Management Fee (i.e., covering the period of one

PR 2001/57

month after acceptance into the Project) of \$7,700, a prepaid Management Fee, for the period 1 August 2001 to 30 June 2002, of \$4,400 and the initial Rent Fee of \$1,100. This Fee is payable in full on application.

35. The Application Monies will be held in the Trust Account by the Responsible Entity under the Project's Constitution.

36. Where the Grower lodges an application and is accepted into the Project prior to 1 June 2001, the services to be carried out for the initial Fees will be completed on or before 30 June 2001. Where the Grower lodges an application and is accepted into the Project after 31 May 2001 and on or before 30 June 2001, the services to be carried out for the initial fees will be commenced from the date of acceptance into the Project and will be completed on or before 31 July 2001.

37. A Management Fee of \$1,586 is payable for services to be carried out in the period commencing 1 July 2002 and continuing until 30 June 2003 and is payable on 1 July 2002.

38. For the years from 1 July 2003 to 30 June 2015, Management Fees are payable by the Grower each year for the Grower's proportion of the estimated management costs (indexed by 3% for the Relevant Financial Year) plus the Grower's proportional interest of the estimated Corporate Costs.

39. Growers who are accepted into the Project before 1 June 2001 must pay rent to the Lessor of an amount of \$1,100 per Licensed area for the initial period from 1 June 2001 to 30 June 2001. Growers who are accepted into the Project after 31 May 2001 and on or before 30 June 2001 must pay rent to the Lessor of an amount of \$1,100 per Licensed area for the initial period from date of acceptance into the Project to 31 July 2001. All Growers pay an amount of \$1,100 for the period 1 August 2001 to 30 June 2002 and per annum thereafter on 1 July of each year which will be indexed by the 3% adjustment factor after year 2 annually. The term of a Grower's Licence is from the Commencement Date until 30 June 2015.

Finance

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

41. This Ruling does not apply if a Grower enters into a finance agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;

- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project are involved, or become involved, in the provision of finance to Growers for the Project.

Ruling

Assessable Income

42. A Grower'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. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

Section 8-1 – Prepaid fees

43. Expenditure incurred by a Grower who participates in the Project is subject to the prepayment rules contained in sections 82KZME and 82KZMF. Therefore, a Grower who prepays fees that are otherwise allowable under section 8-1 **cannot** claim a tax deduction for the full amount of the fees in the year in which the expenditure is incurred unless it is 'excluded expenditure' (see note (ii) below).

44. The amount and timing of tax deductions allowable each year for such fees must be determined using the formula in subsection 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.

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

The application of this method is shown in Example 2 at paragraph 100.

Deductions where a Grower invests in the Project before 1 June 2001 and is not registered nor required to be registered for GST

45. A Grower may claim tax deductions using the methods and Tables in paragraphs 45 and 46, where the Grower:

- participates in the Project before 1 June 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 34-39; and
- is not registered nor required to be registered for GST.

Fee type	ITAA 1997 section	Year 1 deduction (year ended 30/6/01)	Year 2 deduction (year ended 30/6/02)	Year 3 deduction (year ended 30/6/03)
Management fees	Section 8 -1	\$7,700– see notes (i) & (iv) below	\$4,400– see notes (i) & (iv) below	\$1,586– see note (iv) below
Licence Fees (Rent)	Section 8 -1	\$1,100 – see note (iv) below	\$1,100 – see note (iv) below	\$1,133 – see note (iv) below
Interest	Section 8 -1	see notes (ii), (iii) & (iv) below	see notes (ii), (iii) & (iv) below	see notes (ii), (iii) & (iv) below

Notes:

- (i) The Management fees shown in paragraphs 34-39 above are **NOT** deductible in full in the year incurred. The deduction for each year's fees have been determined using the formula above (see paragraph 44). See example 2 at paragraph 100.
- (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

- 101). Deductibility of amounts of \$1,000 or more, such as will occur where a Grower acquires one or more interests in the Project, will be determined on the same basis as the prepaid Management fees, i.e., using the formula shown above (in paragraph 44).
- (iii) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, all Growers who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraphs 72 to 74 below as those rules may be applicable if interest is prepaid.
- (iv) Where a Grower **chooses** to prepay fees beyond 13 months, sections 82KZME and 82KZMF will not apply to set the amount and timing of that Grower's tax 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

46. A Grower who participates in the Project will also be entitled to the following tax deductions:

Fee type	ITAA 1997 section	Year 1 deduction	Year 2 deduction	Year 3 deduction
Establishment of horticultural plants	387-165	Nil - see note (v) and paragraphs 82 and 83 below.	See note (v) and paragraphs 82 and 83 below.	See note (v) and paragraphs 82 and 83 below.

Notes:

- (v) A deduction is allowable under section 387-165 for capital expenditure incurred for the acquisition and establishment of the grapevines for use in a horticultural business. The deduction is allowable when the grapevines, as horticultural plants, enter their first commercial season. If the grapevines 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. The Project's manager will inform Growers of when the grapevines enter their first commercial season.

Deductions where a Grower invests in the Project before 1 June 2001 and is registered or required to be registered for GST

47. Where a Grower who is registered or required to be registered for GST:

- participates in the Project before 1 June 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 34-39; and
- is entitled to an input tax credit for the fees,

then the tax deductions calculated using the methods and Tables in paragraphs 45 and 46 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 99.

Deductions where a Grower invests in the Project after 31 May 2001 and is not registered nor required to be registered for GST

48. A Grower may claim tax deductions using the methods and Tables in paragraphs 48 and 49, where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 34-39; and
- is not registered nor required to be registered for GST.

Fee type	ITAA 1997 section	Year 1 deduction (year ended 30/6/01)	Year 2 deduction (year ended 30/6/02)	Year 3 deduction (year ended 30/6/03)
Prepaid first year Management Fee	Section 8-1	See notes (i) above and (vi) below	See notes (i) above and (vi) below	
Management Fees	Section 8 -1		\$4,400 – see note (iv) above	\$1,586– see note (iv) above
Prepaid first year Licence Fees (Rent)	Section 8-1	See notes (i) above and (vi) below	See notes (i) above and (vi) below	
Licence Fees (Rent)	Section 8 -1		\$1,100- see note (iv) above	\$1,133 – see note (iv) above
Interest	Section 8 -1	see notes (ii), (iii) & (iv) above	see notes (ii), (iii) & (iv) above	see notes (ii), (iii) & (iv) above

Notes:

- (vi) The Project Manager will inform Growers of the number of days in the eligible service period in the first expenditure year. This figure is necessary to calculate the deduction allowable for fees incurred.

Tax deductions for capital expenses

49. A Grower who participates in the Project will also be entitled to the following tax deductions:

Fee type	ITAA 1997 section	Year 1 deduction	Year 2 deduction	Year 3 deduction
Establishment of horticultural plants	387-165	Nil - see note (v) above and paragraphs 82 and 83 below.	See note (v) above and paragraphs 82 and 83 below.	See note (v) above and paragraphs 82 and 83 below.

Deductions where a Grower invests in the Project after 31 May 2001 and is registered or required to be registered for GST

50. Where a Grower who is registered or required to be registered for GST:

- participates in the Project by 30 June 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 34-39; and
- is entitled to an input tax credit for the fees,

then the tax deductions calculated using the methods and Tables in paragraphs 48 and 49 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 99.

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

Section 35-55 – Commissioner’s discretion

51. For a Grower 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 2002 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.

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

- a Grower’s business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or

- the 'Exception' in subsection 35-10(4) applies (see paragraph 87 in the Explanations part of this ruling, below).

53. Where, either the Grower's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

54. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from this perspective has not been made.

Section 82KL

55. Section 82KL does not apply to deny the 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 the licence 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 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 Grower carrying on a business?

58. A viticulture scheme can constitute the carrying on of a business. Where there is a business, or a future business, the Gross Harvest Proceeds each year from grapes from Vineyard Lots comprising 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 grapes each year from the Vineyard Lot.

59. Generally, a Grower will be carrying on a business of viticulture where:

- the Grower has an identifiable interest in specific growing vines coupled with a right to harvest and sell the grapes each year from the vines;
- the viticulture activities are carried out on the Grower's behalf; and
- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

60. For this Project Growers have rights under the Licence and Management Agreement in the form of a licence over an identifiable area of land consistent with the intention to carry on a business of growing vines. Under the Licence and Management Agreement Growers engage the Project Manager to provide ongoing services to care and maintain the vines which have been planted on the licensed land. Growers are considered to have control of their operations.

61. The Licence and Management Agreement provides Growers with more than a chattel interest in the vines. The Project documentation contemplates Growers will have an ongoing interest in the vines.

62. Growers have the right to use the land in question for viticulture purposes and to have the Project Manager come onto the land to carry out its obligations under the Licence and Management Agreement. The Growers' degree of control over the Project Manager as evidenced by the Licence and Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Project Manager's activities. Growers are able to terminate arrangements with the Project Manager in certain instances, such as cases of default or neglect. The viticulture activities described in the Licence and Management Agreement are carried out on the Growers' 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. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

64. Growers will engage the professional services of a manager with appropriate credentials. There is a means to identify which vines Growers have an interest in. These services are based on accepted viticulture practices and are of the type ordinarily found in viticulture ventures that would commonly be said to be businesses.

65. Growers have a continuing interest in the vines from the time they are acquired until the cessation of the Project. The viticulture activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' viticulture activities will constitute the carrying on of a business.

66. The licence fees and management fees associated with the viticulture activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which income (from the regular sale of grapes) is to be gained from the 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 fee 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.

Sections 82KZME and 82KZMF – Prepaid fees

67. Expenditure prepaid by Growers for management fees and licence 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 licence fees incurred by a Grower 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 Grower 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 Grower’s allowable deductions attributable to the Project for each expenditure year exceeds the Grower’s assessable income from the Project (if any) for the expenditure year; and
- the Grower does not have day-to-day control over the operation of the Project; and
- there is more than one Grower participating in the Project.

70. The prepaid management fees incurred by Growers 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 licence fees incurred by Growers 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).

Interest deductibility

72. The deductibility 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. 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 Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in sections 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. It will encompass activities not described in the Arrangement or otherwise dealt with in the Product Ruling, such as a loan to finance participation in the Project.

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 Growers will be required use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. The relevant formula is shown above in paragraph 44 and the method is explained in the Examples at paragraphs 100 and 101.

Prepayments where the eligible service period exceeds 13 months

75. Although not required under the Arrangement described in this Product Ruling, some Growers 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 Grower 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 Grower who is a 'small business taxpayer' (see paragraphs 78 to 80) subsection 82KZM(1) applies to apportion the expenditure and determine the amount and timing of the deductions. Alternatively, for a Grower 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 44 (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.

Small business taxpayers

78. 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.

79. '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).

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

Expenditure of a capital nature

81. Any part of the expenditure of a Grower entering into a viticultural 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 the establishment of horticultural plants are considered to be capital in nature. These costs will be borne by the Manager. The fees for these expenditures are not deductible under section 8-1. However, this expenditure falls for consideration under specific write-off provisions of the ITAA 1997.

Subdivision 387-C - Vines and horticultural provisions

82. Section 387-165 allows capital expenditure on establishing horticultural plants owned and used, or held ready for use, in Australia in a business of horticulture to be written off for tax purposes. A lessee or licensee of land carrying on a business of horticulture is

taken to own the plants growing on that land rather than the actual owner of the land (section 387-210).

83. Under this Subdivision, if the effective life of the plant is less than three years, the expenditure can be written off in full. If the effective life of the plant is more than three years, an annual deduction is allowable on a prime cost basis during the plant's maximum write-off period. The period starts from the time the plant enters its first commercial season. The write-off rate is detailed in section 387-185. For a plant, such as the grapevines in this Project, with an effective life of 13 to 30 years, that rate is 13%. The Applicant has advised that the relevant expenditure attributable to these establishment costs is \$4,066.

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

84. 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.

85. 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.

86. Under the loss deferral rule in subsection 35-10(2) the relevant loss is not able to be taken into account in the calculation of taxable income in the year that loss arose. Instead, in a later year it may be offset against any income from the same or similar business activity or, if one of the objective tests is passed, or the Commissioner's discretion exercised, against other income.

87. 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 Growers who

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

88. 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).

89. A Grower 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 Grower 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. Growers who acquire more than one interest in the Project may, however, pass one of the tests in an earlier income year.

90. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Grower's participation in the Project.

91. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Grower who 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 period up to and including the year ended 30 June 2002.

92. 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.

93. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower'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 51), in the manner described in the Arrangement (see paragraphs 14 to 41), 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.

94. 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 viticulturist provided with the application by the Responsible Entity;
- the draft binding Grape Purchase contract with James Estate Wines Pty Limited for the sale of the grapes setting out prices that realistically reflect the existing market and/or the projected market in the geographical region where the grapes are grown;
- independent, objective, and generally available information relating to the viticulture industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity;
- other expert opinion independently obtained by the Commissioner that specifically relates to the Project.

Section 82KL

95. 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 - general tax avoidance provisions

96. 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).

97. The James Estate Vineyard Project 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 45, 46, 48 and 49 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.

98. 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 grapes. 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 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'

99. 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' showing its ABN and the price of the taxable supply for management services as \$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 – prepaid expenditure and the apportionment of fees

100. 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.

Murray, who is not registered nor required to be registered for GST calculates his tax deduction for management fees for the **2001 income year** as follows:

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

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

= **\$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:

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

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

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

= **\$85** (this represents the portion of the Year 2 prepaid management fees for the 26 days during 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'

101. 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 nor 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:

$$\begin{array}{r} \$3,600 \text{ X } \frac{365}{365} \\ \hline \end{array}$$

= **\$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

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

	Paragraph
What this Product Ruling is about	1
Tax law(s)	2

Goods and Services Tax	3
Business Tax Reform	4
Note to promoters and advisers	6
Class of persons	7
Qualifications	9
Date of effect	11
Withdrawal	13
Arrangement	14
Overview	16
Constitution	23
Compliance plan	25
Interest in Land	26
Licence and Management Agreement	28
Harvesting	32
Fees	34
Finance	40
Ruling	42
Assessable income	42
Section 8-1 – Prepaid fees	43
Deductions where a Grower invests in the Project before 1 June 2001 and is not registered nor required to be registered for GST	45
Tax deductions for capital expenses	46
Deductions where a Grower invests in the Project before 1 June 2001 and is registered or is required to be registered for GST	47
Deductions where a Grower invests in the Project after 31 May 2001 and is not registered nor required to be registered for GST	48
Tax deductions for capital expenses	49
Deductions where a Grower invests in the Project after 31 May 2001 and is registered or required to be registered for GST	50
Division 35 – Deferral of losses from non-commercial business activities	51
Section 35-55 – Commissioner’s discretion	51

Section 82KL	55
Part IVA	56
Explanations	57
Section 8-1	57
Is the Grower carrying on a business?	58
Sections 82KZME and 82KZMF – Prepaid fees	67
Interest deductibility	72
Prepayments where the eligible service period exceeds 13 months	75
Small business taxpayers	78
Expenditure of a capital nature	81
Subdivision 387-C - Vines and horticultural provisions	82
Division 35 – Deferral of losses from non-commercial business activities	84
Section 82KL	95
Part IVA – general tax avoidance provisions	96
Examples	99
Example 1 - Entitlement to ‘input tax credit’	99
Example 2 - Prepaid expenditure and the apportionment of fees	100
Example 3 - Apportionment of fees where there is a contractual ‘eligible service period’ and the fees include expenditure that is ‘excluded expenditure’	101
Detailed contents list	102

Commissioner of Taxation

9 May 2001

Previous draft:

Not previously issued in draft form

- management fees expenses
- primary production
- primary production expenses

Related Rulings/Determinations:

PR 1999/95; PR 2000/85; TR 92/1;
 TR 92/20; TR 98/22; TR 97/11;
 TR 97/16; TD 93/34; IT 175

- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses

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

Legislative references:

- ITAA 1936 82KH(1)
- ITAA 1936 82KH(1F)(b)
- ITAA 1936 82KL
- ITAA 1936 82KL(1)
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZM(1)(b)(ii)
- ITAA 1936 82KZMA
- ITAA 1936 82KZMA(4)
- ITAA 1936 82KZMD
- ITAA 1936 82KZMD(2)
- ITAA 1936 82KZME
- ITAA 1936 82KZME(1)
- ITAA 1936 82KZME(1)(b)
- ITAA 1936 82KZME(3)
- ITAA 1936 82KZME(4)
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- ITAA 1936 82KZMF(1)
- ITAA 1936 Pt IVA
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- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1936 318
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
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- ITAA 1997 17-5
- ITAA 1997 Div 35
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
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- ITAA 1997 387-210
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