



PR 2001/72 - Income tax: TFS Sandalwood Project 2000

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Product Ruling

Income tax: TFS Sandalwood Project 2000

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons and Qualifications sections**), **Date of effect**, **Withdrawal**, **Previous Rulings**, **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 TFS Sandalwood Project 2000, or just simply as 'the Project', or the 'product'.

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 (ITAA 1997);
 - section 17-5 (ITAA 1997);
 - Division 27 (ITAA 1997);
 - Division 35 (ITAA 1997);
 - section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KZL (ITAA 1936);
 - section 82KZM (ITAA 1936);
 - sections 82KZMB - 82KZMF (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling, all fees and expenditure referred to include the Goods and Services Tax (GST) where applicable. In order for an entity (referred to in this Ruling as a 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 of this Ruling. 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 this Ruling.

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 16 to 46) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and

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- the Ruling will be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 30 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).

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

Withdrawal

14. This Product Ruling is withdrawn and ceases to have effect after 30 June 2004. 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.

Previous Rulings

15. This ruling applies to the Project that was ruled upon in Product Ruling PR 2000/113. PR 2000/113 is now withdrawn on and from the date this Ruling is made. The former ruling applies to

Growers who entered the arrangement during the period 15 November 2000 to 29 May 2001 inclusive. This Ruling applies to investors wishing to take up an interest or interests that were not sold prior to 30 May 2001.

Arrangement

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

- Application for Product Ruling, dated 20 July 2000;
- Prospectus issued by TFS Properties Ltd ('Responsible Entity'), dated 2 November 2000;
- Draft Supplementary Prospectus, undated, received 18 May 2001
- Draft **Lease and Management Agreement** ('LMA') between TFS Properties Ltd (in its capacity as both 'Responsible Entity' and 'Lessor') and the Grower, undated, received 23 October 2000;
- Draft Constitution of the TFS Sandalwood Project 2000, undated, received 23 October 2000;
- Draft Compliance Plan for the TFS Sandalwood Project 2000, undated, received 23 October 2000;
- Draft Loan Deed between Arwon Finance Pty Ltd ('the Lender') and 'the Borrower'; and
- Additional correspondence from the Applicant dated 11 October 2000, 18 October 2000, 23 October 2000, 25 October 2000, 20 April 2001, 2 May 2001 and 8 May 2001.

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

17. The documents highlighted are those that Growers 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.

Overview

18. This arrangement is called the TFS Sandalwood Project 2000.

Location	Kununurra, Western Australia
Type of business each participant is carrying on	Commercial growing, and cultivation of Indian Sandalwood (<i>Santalum album</i>) trees for the purpose of harvesting and selling timber.
Number of hectares offered for cultivation	200
Size of each leasehold area	0.167 hectares
Number of Sandalwood trees per hectare	416
Expected production	12,480kg per hectare
The term of the investment	15 years
Initial cost	\$9,350
Initial cost per hectare	\$56,100
Ongoing costs	Lease and Management Fees (may be paid annually, prepaid or deferred). Harvest costs, Selling and Marketing Fees, and Incentive Fees payable from harvest proceeds.

19. Growers participating in the arrangement will enter into a Lease and Management Agreement. The Agreement provides for the Lease of the "Project Land" near the Ord River in Kununurra, Western Australia described as:

- King Location 385 being the whole of the land contained in Certificate of Title Volume 1890 Folio 718.

20. Under this agreement a Grower leases an area of land called a 'Timber Lot' until the final distribution of the sale proceeds is made to the Grower or until the Project is terminated. Each Timber Lot is 0.167 hectares and will be planted with sufficient Sandalwood seedlings and host plants or trees to reasonably provide a survival rate of 416 Sandalwood trees per hectare.

21. Overall, it is proposed to plant 200 hectares representing 1,200 Timber Lots. These Timber Lots are separately identified by a reference number on a plan of the plantation annexed to the agreement. Growers will receive a certificate for the Timber Lots acquired.

22. There is no minimum subscription for the Project. The Responsible Entity (TFS Properties Ltd) is able to accept oversubscriptions to the extent that the Lessor has suitable irrigated land available. TFS Properties undertakes to ensure that all Initial

Services are completed in respect of this Project by 30 June 2001. Applications for this Project will only be accepted after 31 May 2001 where it is reasonably apparent that all of the Initial Services will be able to be completed by 30 June 2001. From 1 June 2001, TFS Properties Ltd will be monitoring on a daily basis its ability to complete those services by 30 June 2001.

23. The Growers will also enter into a contract with the Responsible Entity for the lease and management of their Timber Lot. The Responsible Entity will be responsible for establishing and cultivating the trees and the harvesting of the timber. The trees are expected to be harvested in the year 2016. A Grower may elect within 4 years of the Commencement Date to take their Collectable Produce by giving written notice to the Responsible Entity and thereby become an Electing Grower (clause 17.1) or the Responsible Entity will sell the forest produce on behalf of the Non-Electing Growers for the maximum practicable price (clause 18.1).

24. Growers will execute a Power of Attorney enabling the Responsible Entity, TFS Properties Ltd, to act on their behalf as required, when they make an application for a Timber Lot.

Constitution

25. The Constitution establishes the Project and operates as a deed binding on all of the Growers and the Responsible Entity. The Constitution sets out the terms and conditions under which TFS Properties Ltd agrees to act as Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 26 of the Constitution, the Responsible Entity will keep a register of Growers. Growers may assign their interest in certain circumstances as set out in clause 33 of the Lease and Management Agreement.

Compliance Plan

26. As required by the Corporations Law, a Compliance Plan has been prepared by TFS Properties Ltd. Its purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Lease and Management Agreement

27. Growers participating in the arrangement will enter into a Lease and Management Agreement between TFS Properties Ltd, in its capacity as both 'Responsible Entity' and 'Lessor', and the Grower.

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Growers are granted an interest in land in the form of a lease to use their Timber Lot for the purpose of conducting their afforestation business.

28. Each Grower must pay rent to the Lessor for each year of the Project in an amount specified in clause 4 of the Lease and Management Agreement.

29. Some of the conditions of the lease are that the Grower:

- will not permit the Leased Area to be used for a purpose other than that of commercial silviculture of Sandalwood trees;
- will not use the Leased Area for residential, recreational or tourist purposes; and
- will not install or remove any fixtures, fittings or improvements except with the approval of the Lessor.

30. The Lease and Management Agreement provides that each Grower appoints the Responsible Entity to perform services under the agreement. Items 8A, 8B and 8C of the Schedule specify the services to be performed by the Responsible Entity. The Responsible Entity will supervise and manage all silvicultural activities on behalf of each Grower and must:

- acquire appropriate seeds and seedlings;
- carry out weed control, surveying, ground preparation and mulching of the Leased Area;
- plant Sandalwood seedlings or trees on the land;
- plant other trees as it may consider to be necessary to enable or encourage the growth of the Sandalwood seedlings or trees;
- replant until 30 June 2004 to maintain a minimum stocking of 416 Sandalwood trees per hectare;
- keep access roads in good repair and the Leased Area free from rabbits and other vermin; and
- maintain the Leased Area according to good silvicultural and forestry practices.

Fees

31. Fees are payable to the Responsible Entity by the Grower for each Timber Lot. The following amounts are payable for the Initial Period being the period from the commencement date until 30 June 2001:

- establishment Fees of \$9,350 payable on application, consisting of \$9,075 for Management Fees and \$275 for Rent.

32. After the Initial Period there are three options for the payment of Lease and Management fees. These are described below.

Option 1 - Annual Lease and Management Fees

33. The following amounts are payable:

- for the year commencing 1 July 2001 an amount of \$2,466 is payable for Management Fees (defined as the 'Second Period Management Fee'). The amount of Rent is set at the amount of the fee in the prior year indexed at the greater of 3% per annum (\$283) or the annual rate of inflation. These amounts are payable in two equal instalments on 1 July 2001 and 1 January 2002;
- for the year commencing 1 July 2002 an amount of \$1,304 is payable for Management Fees. The amount of Rent is set at the amount of the fee in the prior year indexed at the greater of 3% per annum or the annual rate of inflation. These fees are payable in two equal instalments on 1 July 2002 and 1 January 2003;
- in each subsequent year the Lease and Management fees will be set at the amount of the fee in the prior year indexed at the greater of 3% per annum or the annual rate of inflation, payable in two equal instalments on 1 July and 1 January of each year. The Responsible Entity will advise the Grower of the amount payable during the month before the due date.

Option 2 - Prepayment of Lease and Management Fees

34. Growers may elect on or before 30 June 2001 to prepay all annual lease and management fees due for the life of the Project after the Initial Period. The amount payable is \$11,000 representing:

- rent of \$2,475; and
- management Fees of \$8,525.

Option 3 - Deferment of Management Fees

35. Growers may elect on or before 30 June 2001 to defer all Management fees payable after the Initial Period until sale of the harvest produce is effected. The following amounts are payable by the Grower under this option:

- management fees of an amount equal to 27.5% of the gross proceeds of sale for each Timber Lot;
- rent is payable for the year commencing 1 July 2001 in two equal instalments on 1 July 2001 and 1 January 2002 at the amount of the fee in the prior year indexed at the greater of 3% per annum or the annual rate of inflation;
- rent is payable for the year commencing 1 July 2002 in two equal instalments on 1 July 2002 and 1 January 2003 at the amount of the fee in the prior year indexed at the greater of 3% per annum or the annual rate of inflation;
- in each subsequent year the amount payable for rent will be the amount in the prior year indexed at the greater of 3% per annum or the annual rate of inflation, payable in two equal instalments on 1 July and 1 January of each year. The Responsible Entity will advise the Grower of the amount payable during the month before the due date.

Other Fees

36. The Grower is also required to pay the following amounts to the Responsible Entity that will be deducted from the gross sales proceeds:

- the Grower's proportional share of the costs of harvest, processing and land restoration;
- a Selling and Marketing Fee equal to 5.5% of the gross proceeds of sale for an electing Grower; and
- an Incentive Fee of an amount equal to 27.5% of the excess of the net proceeds of sale per Timber Lot over the amount estimated by the Responsible Entity.

37. The Responsible Entity will insure the plantation against fire until 30 June 2001. Thereafter, the Responsible Entity will arrange insurance of the Leased Area on behalf of the Grower to cover against fire and windstorm if so requested. Any insurance premiums will be payable by the Grower.

38. Under the terms of the Constitution, all moneys received from applications shall be paid to the Custodian. The Custodian shall deposit those moneys into an Application Fund in the name of the Custodian. The application moneys will be released to the Responsible Entity when the Custodian is reasonably satisfied that certain specified criteria in the Constitution have been met (clauses 14 and 15.1 of the Constitution).

Planting

39. During the Initial Period, the Responsible Entity will be responsible for planting sufficient Sandalwood seedlings or trees on the Leased Area at a rate which would reasonably provide a survival rate of 416 Sandalwood trees per hectare at June 2004. The Responsible Entity will also plant such other trees as may reasonably be necessary or required to encourage the growth of or protect the Sandalwood seedlings or trees. After the Initial Period, the Responsible Entity will maintain the trees in accordance with good silvicultural practice. The Leased Area will be replanted to maintain a rate of 416 Sandalwood trees per hectare on 30 June 2002, 30 June 2003 and 30 June 2004. The services to be provided by the Responsible Entity over the term of the Project are outlined in Item 8 of the Schedule to the Lease and Management Agreement.

Harvesting and Sale

40. At all times the Grower has full right, title and interest in the forest produce and the right to have the forest produce sold for their benefit (clause 19.1). Growers may elect, within 4 years of the acceptance of their application by the Responsible Entity, to take their own Collectable Produce (clause 17) or the Responsible Entity will sell the forest produce on the Grower's behalf for the maximum practicable price available (clause 18.1 and Item 8C).

41. Harvesting will take place not later than 30 June 2016 unless the Responsible Entity believes that it would be in the best interests of the Growers for harvesting to be deferred, such date being no later than 30 June 2018 (clause 16).

42. The Responsible Entity will be entitled to an Incentive Fee. The amount payable by the Grower will be equal to 27.5% of the excess of the Net Proceeds of Sale over the net proceeds of sale per Timber Lot as estimated by the Responsible Entity (clauses 1 and 24). Growers will share the Gross Proceeds of Sale on a proportionate basis, following the payment of harvest and processing costs, selling and marketing fees and any deferred management fees payable by the relevant Grower (clause 20.2).

43. The gross proceeds of sale of the forest produce of Non-Electing Growers will be paid direct to the Responsible Entity who

must deposit them into a Proceeds Fund (clause 20.1 of the LMA and clause 4.2(b) of the Compliance Plan). The Responsible Entity must pay to itself the Grower's proportional share of the costs of harvest, processing and land restoration; the selling and marketing fee; and the deferred management fees if applicable. Within a further 5 business days, the Responsible Entity will pay to itself any other fees or amounts owing to the Responsible Entity or, where applicable, the Lessor. The balance of the Net Proceeds of Sale will be distributed to the Non-Electing Growers on a proportionate basis. The terms 'Proceeds Fund' and 'Proportional Share' are defined in clause 1 of the LMA.

44. If a Grower is an 'Electing Grower' (clauses 1 and 17 of the LMA), the Grower's proportional share of the costs of harvesting and processing, rent owed to the Lessor, the Responsible Entity's remuneration and other amounts owing to the Responsible Entity, are due for payment at the time specified by the Responsible Entity for collection of the Grower's collectable produce (clauses 17.2 and 17.3 of the LMA).

Finance

45. Growers can fund their investment in the Project themselves, borrow from Arwon Finance Pty Ltd (a lender associated with the Responsible Entity) or borrow from an independent lender. The Responsible Entity has however also made arrangements with independent lenders whereby Growers may apply for a finance package to assist in financing the investment. This finance will be on a full recourse basis.

46. 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' 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 terms are of a non-arm's length nature;
- repayments of the principal and 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) back to the lender or any associate;
- 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, other than Arwon Finance Pty Ltd, are involved or become involved, in the provision of finance for the Project.

Ruling

Section 6-5 - Assessable income

47. Gross sale proceeds derived from the sale of timber harvested from the Project, less any GST payable on these proceeds, will be assessable income of the Growers under section 6-5 of the ITAA 1997. Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

Section 8-1

Deductions where Growers are not registered nor required to be registered for GST

48. A Grower may claim the deductions in one of the following tables according to which fee option the Grower elects for fees payable after the Initial Period Establishment Fee where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of afforestation;
- incurs fees as shown in paragraphs 31 to 35 above; and
- is not registered, nor required to be registered for GST.

Option 1 - Annual Lease and Management Fees

49. Where the Grower elects to pay fees annually or fails to elect by 30 June 2001 to either prepay or defer management fees, the following deductions will be available:

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Fee Type	ITAA 1997 Section	Initial Period 30/6/2001	Second Period 30/6/2002	30/6/2003	30/6/2004
Management Fee	8-1	\$9,075	\$2,466 See note (i) below	\$1,304 See note (i) below	See notes (i) & (ii) below
Rent	8-1	\$275	See notes (i) & (ii) below	See notes (i) & (ii) below	See notes (i) & (ii) below
Interest	8-1	See note (iii) below	See note (iii) below	See note (iii) below	See note (iii) below

Notes:

- (i) Where a Grower incurs the Management Fees and Rent as required by the Lease and Management Agreement, those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of management services or the leasing of land) that will not be wholly done within 13 months of the fees being incurred, then the prepayments rules of the ITAA may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraph 68 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being expenditure of less than \$1,000, is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred.
- (ii) Rent is subject to indexation after the Initial Period. Management Fees are subject to indexation in the year commencing 1 July 2003. The amounts payable will be the prior year fee indexed at the greater of 3% per annum or the annual rate of inflation.
- (iii) For a Grower using the finance option offered by Arwon Finance Pty Ltd, interest is deductible in full in the year in which it is incurred. The deductibility or otherwise of interest arising from agreements that Growers enter into with financiers other than Arwon Finance Pty Ltd is outside the scope of this Ruling. However, all Growers who finance their participation in the Project other than with Arwon Finance Pty Ltd should read carefully the discussion of the prepayment rules in paragraphs 67 to 76 below as those rules may be applicable if interest is prepaid.

Option 2 - Prepayment of Lease and Management Fees

50. Where the Grower elects to pay an up front once only payment of \$11,000 per Timber Lot for Lease and Management Fees on or before 1 July 2001, the following deductions will be available:

Fee Type	ITAA 1997 Section	Initial Period 30/6/2001	Second Period 30/6/2002	30/6/2003	30/6/2004
Management Fee	8-1	\$9,075			
Rent	8-1	\$275			
Prepaid Lease and Management Fees	8-1		\$1,100 See note (iv) below	\$1,100 See note (iv) below	\$1,100 See note (iv) below
Interest	8-1	See note (iii) above	See note (iii) above	See note (iii) above	See note (iii) above

Notes:

- (iv) Where fees are prepaid beyond 13 months, the amount and timing of the tax deductions is determined under subsection 82KZM(1) for 'small business taxpayers' or subsection 82KZMD(2) for taxpayers who are not 'small business taxpayers'. These subsections effectively use the same formula to apportion expenditure over the eligible service period or ten years, whichever is the lesser (see paragraphs 71 to 72).

Option 3 - Deferral of Management Fees

51. Where the Grower elects to defer the Second Period Management Fee and the Annual Fee until harvest, the following deductions will be available:

Fee Type	ITAA 1997 Section	Initial Period 30/6/2001	Second Period 30/6/2002	30/6/2003	30/6/2004
Management Fee	8-1	\$9,075	Nil	Nil	Nil
Rent	8-1	\$275	See note (ii) above	See note (ii) above	See note (ii) above
Interest	8-1	See note (iii) above	See note (iii) above	See note (iii) above	See note (iii) above

Deductions where Growers are registered or required to be registered for GST

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

- participates in the Project by 30 June 2001;
- incurs fees as shown in paragraphs 31 to 35 above; and
- is entitled to an input tax credit;

then the deductions shown in the Tables above will exclude any amounts of input tax credit (Division 27 ITAA 1997). See Example 1 at paragraph 102.

Sections 82KZM, 82KZMD, 82KZME - 82KZMF, 82KL and Part IVA

53. For a Grower who invests in the Project and incurs expenditure as required by the Lease and Management Agreement, the following provisions of the ITAA 1936 have applications as indicated:

- expenditure by the Grower does not fall within the scope of section 82KZM except where the Grower has elected to prepay Management Fees as shown in paragraph 50 above (but also see paragraphs 73 to 76);
- expenditure by the Grower does not fall within the scope of section 82KZMD except where the Grower has elected to prepay Management Fees as shown in paragraph 50 above (but also see paragraphs 73 to 76);
- expenditure by the Grower does not fall within the scope of sections 82KZME - 82KZMF above (but see paragraphs 73 to 76);
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Section 35-55 - Losses from non-commercial business activities

54. 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 2015 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.

55. 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 90 in the Explanations part of this Ruling, below).

56. 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 the 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.

Explanations

Section 8-1

57. It is appropriate, as a starting point, to consider whether the lease and management fees are deductible under paragraph 8-1(1)(a). This consideration proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced and, hence, whether paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income of the taxpayer.

58. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross

sale proceeds from the timber's sale from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the trees.

59. Generally, an investor will be carrying on a business of afforestation where:

- the investor has an identifiable interest in specific growing trees coupled with a right to harvest and sell the timber;
- the afforestation activities are carried out on the investor'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, under the Lease and Management Agreement, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the same agreement Growers appoint the Responsible Entity to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees as and when required according to good silvicultural practice. Growers are considered to control their investment. The specific cost of these services provided in the Initial Period to 30 June 2001 will total \$9,350.

61. The Lease and Management Agreement gives Growers an identifiable interest in specific trees and a legal interest in leased land. Growers have the right to personally market and sell the timber attributed to their Leased Area or they may appoint the Responsible Entity to arrange the marketing and sale of the timber for them. Growers will have a continuing interest in the trees.

62. Growers have the right to use the land in question for afforestation purposes and to have the Responsible Entity come onto the land to carry out its obligations under the Constitution and the Lease and Management Agreement. The Growers' degree of control over the Responsible Entity, as evidenced by the Agreements and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Responsible Entity's activities. Growers are able to terminate arrangements with the Responsible Entity in certain instances, such as cases of default or neglect. The afforestation activities described in

the Lease 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. Through the Responsible Entity, Growers will engage the professional services of a Manager with appropriate credentials. There is a means to identify which trees Growers have an interest in. These services are based on accepted silvicultural practices and are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses.

65. Growers have a continuing interest in the trees from the time they are acquired until harvest. The afforestation 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' afforestation activities will constitute the carrying on of a business.

66. The fees associated with the afforestation activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income (from the sale of timber) is to be gained from the business. They will, therefore, be deductible under paragraph 8-1(1)(a). Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under section 8-1 are met. The exclusions do not apply. Section 8-1 is, however, subject to Division 27 of the ITAA 1997.

Prepayments provisions – sections 82KZM, 82KZMD, and 82KZME – 82KZMF

67. The prepayments provisions of the ITAA operate to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

68. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Lease Fees otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means generally, the period over which the services are to be provided, or 10 years, whichever is the lesser. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Grower is a 'small business taxpayer'. However, each prepayment provision uses the same, or effectively the same, formula as that shown below concerning section 82KZMF.

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

Initial Services

69. In this Project, the Management Fee of \$9,075 and a lease fee (Rent) of \$275 per Timber Lot will be incurred on execution of the Lease and Management Agreement. The Management Fee and the Rent are charged for providing management services or leasing land to a Grower by 30 June of the year of execution of the Agreement. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

70. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the Initial Services fee is for the Responsible Entity doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements and as set out in paragraph 49, the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

Ongoing Services - Option 2

71. Growers may elect under Option 2 to prepay Management Fees after the Initial Period for the remaining life of the Project. As the 'eligible service period' relating to the prepaid amount ends more

than 13 months after the Grower incurs the expenditure, for a Grower who is a 'small business taxpayer', 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.

72. 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 68 above. However, the 'eligible service period' as defined in subsection 82KZL(1) is restricted to a maximum of 10 years after the day of the expenditure.

Growers who choose to pay fees for a period in excess of that required by the Project's agreements

73. Although not required under either the Management Agreement or the Lease Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 70 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

74. Where a Grower participating in this Project incurs expenditure in respect of an eligible service period that ends 13 months or less from the time the expenditure was incurred, but also in respect of the doing of a thing not to be wholly done within the income year in which that expenditure has been incurred, and the other tests in section 82KZME are met, then section 82KZMF will apply in the manner set out in the formula above at paragraph 68.

75. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then either section 82KZM or section 82KZMD will apply in the manner described at paragraphs 71 and 72 above.

76. A prepaid management fee and/or a prepaid lease fee of less than \$1,000 incurred in an expenditure year is 'excluded expenditure' as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(7) and 82KZMA(4) all provide that 'excluded expenditure' is an exception to the prepayment rules discussed above. Therefore, a prepaid fee of less than \$1,000 is deductible in full in the year in which it is incurred. However, where a Grower acquires more than one interest in the Project and the quantum of a prepaid lease fee is \$1,000 or more, then the amount and timing of the deduction

allowable must be determined using the relevant formula shown above.

Small business taxpayers

77. 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.

78. '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).

79. 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'.

Interest deductibility

(i) Growers who use Arwon Finance Pty Ltd as the finance provider

80. Some Growers may finance their participation in the Project through a loan facility with Arwon Finance Pty Ltd. Under the terms of the Loan Agreement to be entered into between those Growers and Arwon Finance Pty Ltd, interest must be paid in advance.

81. The interest incurred for the year ended 30 June 2001 and in subsequent years of income will be in respect of a loan to finance the Project business operations of growing trees and is therefore directly connected with the gaining of 'business income' from the Project. Such interest will, therefore, have a sufficient connection with the gaining of assessable income to be deductible under section 8-1, subject to the operation of sections 82KZME and 82KZMF.

82. The loan agreement under which the interest is incurred is directly related to all of the activities that are carried out under the Project, and so is a part of the 'agreement' (subsection 82KZME(4)). Consequently, the interest will satisfy the requirements of subsection 82KZME(1), and be subject to section 82KZMF, unless one of the exceptions applies. For a Grower acquiring a single interest in the Project the prepaid interest will be less than \$1,000 and is therefore 'excluded expenditure' and Exception 3 (subsection 82KZME(7)) will apply. Therefore, the interest is deductible in full in the year in which it is incurred.

83. However, as with the lease fee, where a Grower acquires more than one interest in the Project and the quantum of the interest is \$1,000 or more, the tax deduction each year must be determined in the same manner as the management fees, using the formula in subsection 82KZMF(1).

(ii) Growers who DO NOT use Arwon Finance Pty Ltd as the finance provider

84. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier other than Arwon Finance Pty Ltd 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.

85. 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 for a period that is wholly or partly outside the income year in which the interest is incurred. Unless such prepaid interest is 'excluded expenditure', any tax deduction that may be allowable will be subject to the relevant prepayments provisions of the ITAA. 'Excluded expenditure' is an amount of expenditure that is less than \$1,000.

86. The prepayment provisions are discussed in detail at paragraphs 67 to 76 of this Ruling. However, in broad terms, where interest is prepaid and the period to which the interest relates is wholly or partly outside the income year in which it is incurred, then any tax deduction that is allowable must be determined using the following formula;

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

In the formula, the 'eligible service period' means, generally, the period to which the interest relates.

Division 35 - Losses from non-commercial business activities

87. 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.

88. 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.

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

90. 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.

91. 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).

92. 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 in the Project of one Timber Lot during the year ended 30 June 2001 is unlikely to pass one of the objective tests until the year ended 30 June 2016. Growers who acquire more than one Timber Lot may, however, pass one of the tests in an earlier year.

93. 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.

94. 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) until the year ended 30 June 2015.

95. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised 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.

96. 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 54) in the manner described in the Arrangement (see paragraphs 16 to 46), 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.

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

- the report of the Independent Forester and additional evidence provided with the application by the Responsible Entity;
- independent, objective and generally available information relating to the Indian Sandalwood industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity; and
- other expert opinion independently obtained by the Commissioner that specifically relates to the Project.

Section 82KL

98. 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

99. 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).

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

101. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. 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 are 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.

Example

Example 1 – Entitlement to 'input tax credit'

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

$$\frac{1}{11} \times \$5,500 = \$500$$

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).

Detailed contents list

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Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

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

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses
- management fees
- producing assessable income
- product rulings
- public rulings
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- ITAA 1936 82KL
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZM(1)
- ITAA 1936 82KZMA
- ITAA 1936 82KZMA(4)
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD

- ITAA 1936 82KZMD(2)
- ITAA 1936 82KZME
- ITAA 1936 82KZME(1)
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZME(7)
- ITAA 1936 82KZMF
- 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 8-1(1)(a)
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- ITAA 1997 17-5
- ITAA 1997 Div 27
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-30
- ITAA 1997 35-35
- ITAA 1997 35-40
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ATO references:

NO 2000/0011649

BO

FOI number: I 1024562

ISSN: 1441-1172