



PR 2005/110 - Income tax: NTT Mahogany Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *26 October 2005*



Product Ruling

Income tax: NTT Mahogany Project

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

Preamble

*The number, subject heading, **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **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 Tax Office **does not** sanction or guarantee this product. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

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

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

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

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

Terms of use of this Product Ruling

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

What this Product Ruling is about

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

Tax law(s)

2. The tax laws dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 of the ITAA 1997;
- section 17-5 of the ITAA 1997;
- Division 27 of the ITAA 1997;
- Division 35 of the ITAA 1997;
- Division 328 of the ITAA 1997;
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL of the ITAA 1936;
- sections 82KZME to 82KZMF of the ITAA 1936; and
- Part IVA of the ITAA 1936.

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

Goods and services tax

4. 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.

Changes in the law

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

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

Note to promoters and advisers

7. Product Rulings were introduced for the purpose of providing certainty about tax consequences for participants in projects such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

8. The class of persons to whom this Ruling applies is those who are more specifically identified in the Ruling part of this Product Ruling and 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 (that is, being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling, each of these persons is referred to as 'Growers'.

9. 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. Growers who elect to harvest and market their own timber produce are also excluded from the class of persons to whom this Ruling applies.

Qualifications

10. The Commissioner rules on the precise arrangement identified in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out, the Ruling has no binding effect on the Commissioner. The Ruling will be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 26 October 2005. 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 2007. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the 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 replaces Product Ruling PR 2004/105 which is withdrawn on and from 26 October 2005. PR 2004/105 still applies for 2004 and 2005 Growers in relation to the deductibility of costs incurred between 1 July 2004 and 30 June 2005.

Arrangement

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

- Application for Product Ruling dated 19 June 2003, received 24 June 2003 and additional correspondence, including emails, received 10 September 2003, 9 October 2003 and 29 October 2003;
- Additional correspondence received 19 February 2004, 19 March 2004, 22 March 2004, 27 March 2004, 29 March 2004, 1 April 2004, 14 April 2004, 17 September 2004, 23 September 2004, 12 October 2004, 13 October 2004, 21 October 2004, 4 November 2004, 29 June 2005, 5 August 2005 and 5 October 2005;
- Product Disclosure Statement (PDS) for the NTT Mahogany Project to be issued by Primary Securities Ltd ('Responsible Entity'), received 13 October 2004;
- Supplementary Product Disclosure Statement dated 9 January 2004 received 13 October 2004;
- Supplementary Product Disclosure Statement No. 2 dated 16 June 2004 received 3 November 2004;
- Constitution for the NTT Mahogany Project, dated 13 October 2003;
- **Project Operations Agreement** between Primary Securities Ltd and the Grower, received 13 October 2004;
- **Licence Agreement** between NTT Land Holdings (the Licensor), Primary Securities Ltd and the Grower, received 29 June 2005;
- Standing Offer – Licence between Primary Securities Ltd and NTT Land Holdings Pty Ltd (the land owner), received 13 October 2004;
- Responsible Entity Services Agreement between Northern Tropical Timbers Pty Ltd (Plantation Manager) and Primary Securities Ltd, received 13 October 2004;
- Draft Forestry Management Plan, dated 21 October 2004, received 21 October 2004;
- Project Management Agreement between Primary Securities Ltd and Northern Tropical Timbers Pty Ltd, received 18 March 2004;
- Compliance Plan for the NTT Mahogany Project, dated 28 January 2003, received 24 June 2003; and

- Variation to Project Operations Agreement NTT Mahogany Project received 5 August 2005.

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 may enter into. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are a part of the arrangement to which this Ruling applies.

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

Overview

19. This arrangement is called the NTT Mahogany Project. The salient features are as follows:

Location	Cape York region in North Queensland and the Northern Savanna region in the Northern Territory.
Type of business each participant is carrying on	Commercial growing and cultivation of <i>Khaya senegalensis</i> (African Mahogany) for the purpose of producing timber.
Number of hectares offered for cultivation	880
Minimum allocation	2 Woodlots
Size of each Woodlot	0.22 hectares
Number of trees established	408 trees per hectare planted
The term of the Project	Approximately 16 years
Initial cost per woodlot	\$3,366
Initial cost per hectare	\$16,830
Ongoing and other costs per woodlot	Ongoing Licence Fee of \$68.75, indexed after 1 July 2006 Management Fee of \$715 from Plantation Establishment to the end of that financial year Ongoing Management Fee of \$275 indexed after 1 July 2006 Potential Performance Bonus Costs of harvest and sale payable out of harvest proceeds Marketing Fee of 5% of net harvest proceeds

20. The Project is registered as a Managed Investment Scheme under the Corporations Act. The Responsible Entity for the Project is Primary Securities Ltd. The Project will be conducted on land located near Cooktown in far north Queensland on a property known as 'Elderslie'. Elderslie is described as the whole of the land of Lot 176 on Crown Plan BS24, County of Banks, Parish of Mclvor and on further land that will be acquired in the Cape York region of North Queensland or in the Northern Savanna region in the Northern Territory.

21. This offer pertains to 4,000 Woodlots of 0.22 hectares each. There is a minimum subscription of 450 Woodlots for this Project. Growers must subscribe for a minimum of two Woodlots. However, the Responsible Entity has discretion to accept applications for less than two Woodlots (Clause 3 of the Constitution).

22. Growers participating in the arrangement will enter into a Licence Agreement. Under this Agreement, Growers licence an area of land called a 'Woodlot' for a term of approximately 16 years for the purpose of Tree Farming. Each Woodlot will be planted with Mahogany seedlings at the rate of 408 trees per hectare.

23. Under this offer, Growers may enter the Project in either the 2004 income year or the 2005 income year. Growers who are allotted Woodlot/s during the year ended 30 June 2004 are defined as '2004 Growers' for the purpose of this Ruling. Growers who are allotted Woodlot/s during the year ended 30 June 2005 are defined as '2005 Growers'.

24. The Growers will also enter into a Project Operations Agreement with the Responsible Entity for the management of their Woodlot. The Responsible Entity sub-contracts the Plantation Manager to provide these services. The Plantation Manager will be responsible for establishing and cultivating the Trees. Growers may elect to harvest and sell their own timber by notice in writing to the Responsible Entity by 30 June 2005. Alternatively, the Responsible Entity will harvest and sell the timber on their behalf. A non-commercial thinning of 204 Trees per hectare will be undertaken prior to year 6. Harvests are expected to take place when the Trees are aged 10, and 15 years.

25. The Responsible Entity will only accept applications made by Growers where Subscription Monies are paid in full. However, a 2004 Grower only, may elect to pay half of the Subscription Monies with the application and pay the balance by 31 December 2004.

26. The Licence and Project Operations Agreement come into effect on acceptance of a Grower's Application by the Responsible Entity.

Constitution

27. 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 Primary Securities Ltd agrees to act as Responsible Entity and thereby operates the Project. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance plan

28. As required by the Corporations Act, a Compliance Plan has been prepared by Primary Securities 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.

Licence

29. Primary Securities Ltd procures the land from the land owner, NTT Land Holdings Pty Ltd, a Standing Offer to enter into the Licence. Growers participating in the arrangement will then enter into a Licence Agreement with Primary Securities Ltd in its capacity as Responsible Entity and NTT Land Holdings Pty Ltd. Growers are granted a Licence to use their Woodlot for the purpose of conducting their afforestation business upon the terms and conditions as set out in the Licence. The Licence will commence on the date Woodlots are allotted to Growers and will continue until the completion of the final harvest in approximately 16 years.

30. Each Grower must pay a Licence Fee to the Licensor during the Term of the Project being an amount specified in Item 5 of the Schedule to the Licence Agreement (see paragraph 36).

Project Operations Agreement

31. The Project Operations Agreement is between the Grower and Primary Securities Ltd as the Responsible Entity. Each Grower agrees to engage the Responsible Entity of the Project to perform services under the Agreement. The Responsible Entity may arrange for a contractor to carry out some or all of these duties. The Responsible Entity, by execution of the Management Agreement, contracts Northern Tropical Timbers Pty Ltd to manage the Woodlots.

32. The Project Operations Agreement sets out all the services to be performed under this agreement. The Plantation Establishment Services are defined as all services to be performed under the Project Operations Agreement relevant to the main planting and establishment of the Trees on the Woodlots. These include:

- tending to the seedlings prior to planting;
- ripping;

- mounding;
- applying fertiliser or herbicide to the seedlings prior to and during planting; and
- planting the seedlings.

33. The Plantation Establishment Services will be completed within 12 months of the Growers application being accepted. This is set out in the Forestry Management Plan.

34. The Plantation Manager will perform the ongoing services required to carry out a business of tree farming. These services include:

- tending to the Trees according to the principles of good forestry; including such nutrient analysis, pruning, fertilising and fumigating, as the Plantation Manager deems appropriate to promote Tree growth and yields;
- maintaining and repairing the irrigation system and such roads and fences as exist on the Land and otherwise keep the Woodlots in good and substantial repair and condition;
- managing the Tree crop in accordance with the Forestry Management Plan; and
- determining the harvest schedule and manage each harvest.

Management Agreement

35. The Management Agreement is between Primary Securities Ltd as the Responsible Entity and Northern Tropical Timbers Pty Ltd as Plantation Manager. This Agreement appoints Northern Tropical Timbers Pty Ltd to perform the obligations of the Responsible Entity under the Project Operations Agreement.

Fees

36. The fees payable under the Licence and the Project Operations Agreement on a per Woodlot basis are as follows:

- Licence Fee of \$68.75 on Application for a twelve month period from the Anniversary Date of Allotment. It is payable annually. The amount will be indexed by 3% per annum or the increase in the Consumer Price Index, whichever is the greater; and
- Management Fee of \$3,297.25 payable on application. \$715 payable within 30 days of completion of the Plantation Establishment Services until the end of that financial year. Thereafter, an annual fee of \$275. The amount will be indexed by 3% per annum or the increase in the Consumer Price Index, whichever is the greater.

The Responsible Entity can, with the approval of the Forestry Expert, increase the Management Fee above the indexation where the costs to the Responsible Entity of providing the Management Services are greater than the Management Fee received from the Grower (clause 4.3 of the Project Operations Agreement).

Other fees

37. The Grower is also required to pay an Incentive Share to the Responsible Entity if the average sawn timber per woodlot exceeds 18.5m³ (clause 4.1(d) and the Appendix to the Project Operations Agreement).

Payment of fees

38. Upon signing an Application Form, the Grower acknowledges that the full amount of the Subscription Money is immediately due and payable. All amounts are expressed on a per Woodlot basis.

Growers who enter the project on or before 30 June 2004

- \$3,366 payable on application. A grower can elect to pay in full on application or \$1,683 on application and \$1,683 by 31 December 2004;
- \$715 Management Fee payable within 30 days of completion of the Plantation Establishment Services;
- \$275 Management Fee payable annually from 1 July 2005. This amount is subject to indexation; and
- \$68.75 Licence Fee payable every twelve months on the Anniversary Date of Allotment. This amount is subject to indexation.

Growers who enter the project after 30 June 2004 and on or before 31 March 2005

- \$3,366 payable on application;
- \$715 Management Fee payable within 30 days of completion of the Plantation Establishment Services;
- \$275 Management Fee payable annually from 1 July 2006. This amount is subject to indexation; and
- \$68.75 Licence Fee payable every twelve months on the Anniversary Date of Allotment. This amount is subject to indexation.

Growers who enter the project between 1 April 2005 and 30 June 2005

- \$3,366 payable on application;
- \$715 Management Fee payable within 30 days of completion of the Plantation Establishment Services;

- \$275 Management Fee payable annually on 1 July 2006. This amount is subject to indexation; and
- \$68.75 Licence Fee payable every twelve months on the Anniversary Date of Allotment. This amount is subject to indexation.

Planting

39. Under the Project Operations Agreement the Grower agrees to engage the Responsible Entity to select and purchase plant-stock to enable the cultivation of trees. During the Plantation Establishment Period, the Plantation Manager will plant sufficient Trees to an average of 82 trees per Woodlot. The Plantation Manager will conduct a survival count within 13 months of planting the Trees and replant as necessary. The Manager will then maintain the Trees in accordance with the principles of good forestry.

Harvesting and marketing

40. The Grower has an interest in the Trees to be planted on the Woodlot and a right to the Timber from those Trees. Harvesting will take place as and when deemed appropriate by the Responsible Entity and the Plantation Manager in producing the best overall result for the Grower. The Manager expects to conduct non-commercial thinning of 50% of the Trees in year 6 and a harvest of 25% in year 10. The remaining Trees will be harvested in the final year of the Project.

41. The proceeds from sale of the Grower's Timber will be paid direct to the Responsible Entity which must then be deposited into a Trust Account. Proceeds received by the Responsible Entity are to be distributed in the following order of priority:

- to pay the Adjusted Prescribed Proportion of the costs of sale (unless the Grower has made an election to sell their Timber under the Projects Operations Agreement);
- to pay to the Responsible Entity any outstanding Project Fees or other fees (including the marketing fee), costs, interest or taxes owing by the Grower to the Responsible Entity under the Constitution;
- to pay to the Responsible Entity a reasonable estimate of the following 12 months estimated project fees that may be required;
- to pay the Plantation Manager any amounts due under the Project Operations Agreement;
- to pay any amounts due to the Licensor under the Licence; and

- distribute the balance to the Grower provided that if the aggregate sum to be distributed to all of the Growers is less than \$1,000, then, at the discretion of the Responsible Entity, distribution may be postponed (clause 12 of the Constitution).

Finance

42. Growers can fund their participation in the Project themselves or borrow from an independent lender.

43. 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 or rate of interest 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 are involved in the provision of finance for the Project.

Ruling

Application of this Ruling

44. This Ruling applies only to Growers who are accepted to participate in the Project:

- on or before 30 June 2004 where the Grower has executed Licence and Management Agreements on or before that date (2004 Growers); and

- on or before 30 June 2005 where the Grower has executed Licence and Management Agreements on or before that date (2005 Growers).

Minimum subscription

45. The Grower's participation in the Project must constitute the carrying on of a business of primary production. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the Project is accepted and the Project has commenced. Under the terms of the PDS, a Grower's application will not be accepted and the Project will not proceed until the minimum subscription of 450 Woodlots is achieved.

The Simplified Tax System (STS)***Division 328***

46. For a Grower who is accepted into this Project, the recognition of income and the timing of tax deductions will depend upon whether, in an income year(s), the Grower is an 'STS taxpayer' or is not an 'STS taxpayer'. To be an 'STS taxpayer' a Grower:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

47. Changes to STS apply from 1 July 2005. This allows STS taxpayers to choose between the cash or the accruals accounting methods.

Qualification

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

Tax outcomes for Growers who are not 'STS taxpayers' using the cash accounting method**Assessable income****Section 6-5**

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

50. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is derived.

Deductions for Management Fee and Licence Fee**Section 8-1**

51. A Grower who is not an 'STS taxpayer' using the cash accounting method may claim tax deductions under section 8-1 of the ITAA 1997, for the revenue expenses in the following Tables.

2004 Growers Per Woodlot Basis

Fee Type	ITAA 1997 section	Year ended 30 June 2006
Management Fee	8-1	\$275 See Notes (i) & (ii)
Licence	8-1	\$68.75 See Notes (i) & (iii)

2005 Growers Per Woodlot Basis

Fee Type	ITAA 1997 section	Year ended 30 June 2006	Year ended 30 June 2007
Management Fee	8-1	\$715 See Notes (i) & (ii)	\$275 See Notes (i) & (ii)
Licence	8-1	\$68.75 See Notes (i) & (iii)	\$68.75 See Notes (i) & (iii)

Notes:

- (i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (for example input tax credits): Division 27. See Example 1 at paragraph 94.

- (ii) Where a Grower who is not an 'STS taxpayer' using the cash accounting method, pays the Management Fee in the relevant income years shown in the Project Operations Agreement, those fees are deductible in full in the year that they are incurred. However, if a Grower **chooses** to prepay fees for the doing of a thing (for example the provision of management services or the leasing of land) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA 1936 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 83 unless the expenditure is 'excluded expenditure'. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than \$1,000.
- (iii) Where a Grower who is not an 'STS taxpayer' using the cash accounting method, pays the Licence Fee in the relevant income years shown in the Licence, those amounts are a prepayment. The prepayment rules of the ITAA 1936 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 83 unless the expenditure is 'excluded expenditure'. For the purpose of this Ruling the Licence Fee is excluded expenditure as it is an amount of expenditure of less than \$1,000, where the Grower purchases 14 Woodlots or less. See Example 2 at paragraph 95.

Tax outcomes for Growers who are 'STS taxpayers' using the cash accounting method

Assessable income

Section 6-5 and section 328-105

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

53. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is received.

Deductions for Management Fee and Licence Fee

Section 8-1 and section 328-105

54. A Grower who is an 'STS taxpayer' using the cash accounting method may claim tax deductions for the revenue expenses in the following Table. Deductions will be available in accordance with the year in which the Grower commences participation in the Project.

PR 2005/110

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

2004 Growers Instalment Payments

Fee Type	ITAA 1997 section	Year ended 30 June 2006
Management Fee	8-1	\$275 See Notes (iv) & (vi)
Licence	8-1	\$68.75 See Notes (iv) & (vii)

2004 Growers Per Woodlot Basis

Fee Type	ITAA 1997 section	Year ended 30 June 2006
Management Fee	8-1	\$275 See notes (iv) & (v)
Licence	8-1	\$68.75 See notes (iv) & (vi)

2005 Growers Per Woodlot Basis

Fee Type	ITAA 1997 section	Year ended 30 June 2006	Year ended 30 June 2007
Management Fee	8-1	\$715 See Notes (iv) & (v)	\$275 See Notes (iv) & (v)
Licence	8-1	\$68.75 See Notes (iv) & (vi)	\$68.75 See Notes (iv) & (vi)

Notes:

- (iv) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (for example input tax credits): Division 27. See Example 1 at paragraph 95.

- (v) Where a Grower who is an 'STS taxpayer' using the cash accounting method, pays the Management Fee in the relevant income years shown in the Project Operations Agreement, those fees are deductible in full in the year that they are paid. However, if a Grower chooses to prepay fees for the doing of a thing (for example the provision of management services) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA 1936 may apply to apportion those fees (see paragraphs 77 to 84). In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraph 83, unless the expenditure is 'excluded expenditure'. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than \$1,000.
- (vi) Where a Grower who is an 'STS taxpayer' using the cash accounting method, pays the Licence Fee in the relevant income years shown in the Licence, those amounts are a prepayment. The prepayment rules of the ITAA 1936 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 83 unless the expenditure is 'excluded expenditure'. For the purpose of this Ruling the Licence Fee is excluded expenditure as it is an amount of expenditure of less than \$1,000, where the Grower purchases 14 Woodlots or less. See Example 2 at paragraph 94.

Tax outcomes that apply to all Growers

Interest

56. The deductibility or otherwise of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier is outside the scope of this Ruling. However all Growers who borrow funds in order to participate in the Project, should read the discussion of the prepayment rules in paragraphs 77 to 84 as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Growers choice.

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

57. For a Grower who is an individual, enters the Project during the years ended 30 June 2004 or 30 June 2005 may have losses arising from their participation in the Project that would be deferred to a later income year under section 35-10. Subject to the Project being carried out in the manner described above, the Commissioner will exercise the discretion in paragraph 35-55(1)(b) for these Grower for the years ending 30 June 2004 to 30 June 2018. This conditional exercise of the discretion will allow those losses to be offset against the Grower’s other assessable income in the income year in which losses arise.

Section 82KL and Part IVA

58. For a Grower who participates in the Project and incurs expenditure as required by the Licence Agreement and the Project Operations Agreement, the following provisions of the ITAA 1936 have application as indicated:

- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Explanation**Is the Grower carrying on a business?**

59. For the amounts set out in the Tables above to constitute allowable deductions, the Grower’s activities as a participant in the NTT Mahogany Project must amount to the carrying on of a business of primary production.

60. Where there is a business, or a future business, the gross proceeds from the sale of timber from the Project will constitute assessable income in their own right. The generation of ‘business income’ from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income.

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

62. Generally, an investor will be carrying on a business of afforestation, and hence primary production, if:

- the Grower has an identifiable interest (by lease or licence) in the land on which the Grower's trees are established;
- the Grower has a right to harvest and sell the timber from those trees;
- the afforestation activities are carried out on the Grower's behalf;
- the afforestation activities of the Grower are typical of those associated with an afforestation business; and
- the weight and influence of general indicators point to the carrying on of a business.

63. In this Project each Grower enters into a Licence and a Project Operations Agreement.

64. Under the Licence Agreement each individual Grower will have rights in the form of a Licence over a specific and identifiable area of land. The Project Operations Agreement provides the Grower with an ongoing interest in the specific Trees on the licenced area for the term of the Project. Under the Licence, the Grower must use the land in question for the purpose of carrying out afforestation activities, and for no other purpose. The Project Operations Agreement allows the Responsible Entity to come onto the land to carry out its obligations under any of the agreements.

65. Under the Project Operations Agreement the Responsible Entity is engaged by the Grower to establish and maintain the Grower's identifiable area of land during the term of the Project. The Responsible Entity will subcontract the management services to the Plantation Manager, under the Management Agreement. The Plantation Manager has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the licenced area on the Grower's behalf.

66. The Responsible Entity, may also be engaged to harvest and sell, on the Grower's behalf, the timber grown on the Grower's licenced area.

67. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the Project's description for all the indicators.

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

69. The pooling of timber grown on the Grower's licenced area with the timber of other Growers is consistent with general afforestation practices. Each Grower's proportionate share of the sale proceeds of the pooled timber will reflect the proportion of the Trees contributed from their licenced area.

70. The Responsible Entity's services are also consistent with general afforestation practices. They are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses. While the size of a Woodlot is relatively small, it is of a size and scale to allow it to be commercially viable (see Taxation Ruling TR 2000/8).

71. The Grower's degree of control over the Responsible Entity as evidenced by the Project Operations Agreement, and supplemented by the Corporations Act, is sufficient. During the term of the Project, the Responsible Entity will provide the Grower with regular progress reports on the Grower's licenced area and the activities carried out on the Grower's behalf. Growers are able to terminate arrangements with the Responsible Entity in certain instances, such as cases of default or neglect.

72. 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. For the purposes of this Ruling, the Grower's afforestation activities in the NTT Mahogany Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

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

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

Deductibility of Licence and Management Fees

Section 8-1

75. Consideration of whether the Licence and Management Fees are deductible under section 8-1 begins with the first limb of the section. This view 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 outgoings are not deductible under the second limb if they are incurred before the business has 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.

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

Prepayment provisions

Sections 82KZL to 82KZMF

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

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

Sections 82KZME and 82KZMF

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

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

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

81. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)). This has particular relevance for a Grower in this Project who, in order to participate in the Project may borrow funds from a financier. Although undertaken with an unrelated party, that financing would be an element of the arrangement. The funds borrowed and the interest deduction is directly related to the activities under the arrangement. If a Grower prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF.

82. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than \$1,100. Such expenditure is immediately deductible.

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

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

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

Application of the prepayment provisions to this Project

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

85. Although not required under the Project Operations Agreement, a Grower participating in the Project may choose to prepay the Management Fee or interest for a period beyond the 'expenditure year'. Similarly, Growers who use financiers may either choose, or be required to prepay interest. Where this occurs, contrary to the conclusion reached in paragraph 93, section 82KZMF will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

86. For these Growers, the amount and timing of deductions for any relevant prepaid Management Fee or prepaid interest will depend upon when the respective amounts are incurred and what the 'eligible service period' is in relation to these amounts.

87. However, as noted above, prepaid fees of less than \$1,000 incurred in an 'expenditure year' will be 'excluded expenditure' and will be not subject to apportionment under section 82KZMF.

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

88. In deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for the income years 30 June 2004 to 30 June 2018 the Commissioner has applied the principles set out in Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses. Accordingly, based on the evidence supplied, the Commissioner has determined that for those income years ended 30 June 2004 up to and including 30 June 2018:

- it's because of its nature the business activity will not satisfy one of the four tests set out in Division 35;

- there is an objective expectation that within a period that is commercially viable for the afforestation industry, a Grower's business activity will satisfy one of the four tests set out in Division 35 or produce a taxation profit; and
- a Grower who would otherwise be required to defer a loss arising from their participation in the Project under subsection 35-10(2) until a later income year is able to offset that loss against their other assessable income.

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

Section 82KL

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

Part IVA – general tax avoidance provisions

91. 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).

92. The NTT Mahogany Project will be a 'scheme' commencing with the issue of the Product Disclosure Statement. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 51 and 55 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.

93. 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.

Examples

Example 1 – entitlement to GST input tax credits

94. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001 Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2002 to 30/6/2002	\$4,400*
Carrying out of upgrade of power for your vineyard as quoted	<u>\$2,200*</u>
Total due and payable by 1 January 2002 (includes GST of \$600)	\$6,600

*Taxable supply

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

$$\frac{1}{11} \times \$4,400 = \$400$$

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

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

$$\frac{1}{11} \times \$2,200 = \$200$$

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

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as \$4,000 (not \$4,400).

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

Example 2 – apportionment of fees where there is a contractual ‘eligible service period’ and the fees include expenditure that is ‘excluded expenditure’

95. On 1 June 2002 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 1 hectare Woodlot and the provision of management services between the 1 July and 30 June in the following income year. On 15 June 2002 Kevin pays the Year 1 lease fee of \$400 and the Year 1 management fee of \$8,600. The Year 1 management fee is made up of \$7,500 for ‘seasonally dependent agronomic activities’ undertaken by the manager during the ‘establishment period’ and \$1,100 for other management services.

Kevin, who is not an ‘STS taxpayer’ is not registered, nor required to be registered for GST.

He calculates his tax deduction for management fees and the lease fee for the 2002 income year as follows:

Management fee

Even though he paid the \$8,600 in the 2002 income year, Kevin is only able to claim a deduction of \$7,500 for the ‘seasonally dependent agronomic expenditure’ in that income year. Because there are no ‘days of eligible service period’ in the 2002 income year, Kevin is unable to claim any part of the management fees paid to the manager for other management services, as a tax deduction in his tax return for the year ended 30 June 2002.

Lease fee

Because the \$400 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 2002.

In the 2003 income year Kevin can claim a tax deduction for that part of his first year’s management fees that was not deductible in the 2002 income year. The tax deduction is calculated as follows:

$$\$1,100 \times \frac{365}{365}$$

= \$1,100 (this represents the whole of that part of the first year’s management fee prepaid in the 2002 income year for management services that are not ‘seasonally dependent agronomic activities’ undertaken by the manager in the ‘establishment period’. Although this amount was incurred in the 2002 income year it is not deductible until the 2003 income year).

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

Detailed contents list

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Commissioner of Taxation

26 October 2005

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

PR1999/95; TR 92/1; TR 92/20;
 TR 97/11; TR 97/16; TR 98/22;
 TR 2000/8; TR 2001/14; TD 93/34

Previous Rulings/Determinations:

PR 2004/105

Subject references:

- advance expenses & payments for certain forestry expenditure
- carrying on a business
- commencement of business
- fee expenses
- forestry agreement
- interest expenses
- management fees
- non-commercial losses
- producing assessable income
- product rulings
- public rulings
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

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- ITAA 1936 Pt III Div 3 SubdivH
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB

- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
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- ITAA 1997 17-5
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ATO references

NO: 2003/1555

ISSN: 1441-1172

ATOlaw topic: Income Tax ~~ Product ~~ timber