



PR 2006/21 - Income tax: Oak Valley Truffle Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *22 March 2006*



Product Ruling

Income tax: Oak Valley Truffle Project

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❶ This Ruling provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

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 scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document.

If the scheme 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 scheme 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 scheme has been implemented as described below and to ensure that the participants in the scheme 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 entity(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 'taxation provisions' identified below apply to the defined class of entities who take part in the scheme to which this Ruling relates.

Relevant taxation provision(s)

2. The taxation provisions 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;
 - section 70-35 of the ITAA 1997;
 - section 108-5 of the ITAA 1997;
 - Division 110 of the ITAA 1997;
 - Division 328 of the ITAA 1997;
 - Division 328 of the *Income Tax (Transition Provisions) Act 1997*;
 - section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KZME of the ITAA 1936;
 - section 82KZMF of the ITAA 1936; and
 - Part IVA of the ITAA 1936.

All legislative references in this Ruling are to the ITAA 1997 unless otherwise indicated.

Goods and Services Tax

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

Changes in the Law

4. Although this Ruling deals with the 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.

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

Note to promoters and advisers

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

Class of entities

7. The class of entities to whom this Ruling applies is the persons who enter into the scheme, specified below, on or after the date this Ruling is made. They will have a purpose of staying in the scheme until it is completed (that is, being a party to the relevant Agreements until their term expires) and deriving assessable income from this involvement. In this Ruling, these persons are referred to as 'Growers'.

8. The class of entities to whom this Ruling applies does not include persons who:

- intend to terminate their involvement in the scheme prior to its completion or who otherwise do not intend to derive assessable income from it; or
- have entered into the scheme specified below prior to the date this Ruling is made or after 31 May 2006.

Qualifications

9. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 15 to 53.

10. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 22 March 2006, 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 that private ruling if the income year to which it relates has ended or has commenced but not yet ended. However if the scheme covered by the private ruling has not commenced, and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

14. This Product Ruling is withdrawn and ceases to have effect after 30 June 2008. 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 scheme specified below. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified scheme prior to withdrawal of the Ruling. This is subject to there being no change in the scheme or in the person's involvement in the scheme.

Scheme

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

- Application for Product Ruling as constituted by documents provided on 26 October 2005 and additional correspondence received 20 December 2005, 9 January 2006, 23 January 2006, 21 February 2006, 22 February 2006, 27 February 2006 and 8 March 2006;
- Draft Prospectus and Product Disclosure Statement of the Oak Valley Truffle Project received 21 February 2006;
- Draft **Constitution** of the Oak Valley Truffle Project received 22 February 2006;
- **Draft Lease and Sub-Lease for Growers** of the Oak Valley Truffle Project, between Truffle Properties Ltd ('Land Owner'), Watershed Premium Wines Ltd (Responsible Entity) and the Grower received 8 March 2006;
- **Draft Project Operations Agreement for Growers** of the Oak Valley Truffle Project between Watershed Premium Wines Ltd ('Responsible Entity') and the Grower received 8 March 2006;
- Draft Compliance Plan for the Oak Valley Truffle Project received 26 October 2005;
- Draft Marketing and Management Agreement of the Oak Valley Truffle Project, between Truffle Projects Pty Ltd ('Manager') and Watershed Premium Wines Ltd (Responsible Entity) received 9 January 2006; and
- **Terms Agreement for 2006 Growers** for the Oak Valley Truffle Project between Watershed Premium Wines Ltd ('Responsible Entity') and the 2006 Terms Grower received 26 October 2005.

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

16. The documents highlighted are those that the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or an associate of the Grower will be a party to that are part of the scheme to which this Ruling applies.

17. All Australian Securities and Investments Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of the agreements may be summarised as follows.

Overview

18. The scheme is called the 'Oak Valley Truffle Project' and is summarised as follows:

Location	Near Manjimup in the South West of Western Australia
Type of business	Trufferie
Name of development	Oak Valley Truffle Project
Size of each interest	0.2 hectare
Number of interests available	374
Number of trees per interest	100 trees
Minimum subscription	50 Trufferies
The term of the Project	20 Years
Initial cost per interest	\$9,433.60
Initial costs per hectare	\$47,168
Subscription for 3,508 shares in Landholder	\$7,016 at \$2.00 per share for shares in Truffle Properties Ltd paid on application.
Ongoing costs	Annual management fees, annual lease fees, harvesting and sales costs and insurance costs

19. The Oak Valley Truffle Project is registered as a Managed Investment Scheme under the *Corporations Act 2001*. The Responsible Entity for the Project is Watershed Premium Wines Ltd. Under the Product Disclosure Statement and Prospectus, Watershed Premium Wines Ltd proposes to offer 374 interests called Trufferies of 0.2 hectares each.

20. The Project Land is situated approximately 10kms south-west of Manjimup in the south-west of Western Australia. The Project Land will be owned by Truffle Properties Ltd (the 'Land Owner') and will be leased by the Land Owner to the Grower.

21. There is a minimum subscription of 50 Trufferies required for the Project. The Responsible Entity will not be accepting oversubscriptions for the Project.

22. An interest in the Project is offered under a combined Prospectus and Product Disclosure Statement ('PDS'). The offer is a stapled interest. Each Applicant may subscribe for a minimum of one Trufferie and must purchase 3,508 shares in the Land Owner for each Trufferie subscribed to. The shares can be held by any entity and can be held in a different name from the Trufferie owner. Once the Responsible Entity has allotted a Trufferie to a Grower, the offer is no longer stapled and the shares can be transferred separately to the interest in the Trufferie.

23. Upon Application, the Grower will grant a Power of Attorney enabling the Responsible Entity to execute:

- a Lease and Sub-lease For Growers Agreement between the Land Owner, the Responsible Entity and the Grower;
- a Project Operations Agreement between the Responsible Entity and the Grower; and
- the application for shares in Truffle Properties Limited.

Constitution

24. The Constitution sets out the terms and conditions under which Watershed Premium Wines Ltd agrees to act as the Responsible Entity and thereby manage the Project. The Responsible Entity will maintain a register of Growers. The Lease and Sub-lease and Project Operations Agreements will come into effect on acceptance of a Grower's Application by the Responsible Entity. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance Plan

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

Interest in Land

26. Under the Lease and Sub-lease for Growers Agreement, Truffle Properties Limited (the 'Land Owner') agrees to lease to the Grower an identifiable area of land (a 'Grower's Trufferie') for the purpose of cultivating the Hazelnut and Oak trees and harvesting truffles until the Project is terminated on 30 June 2026. The terms and conditions under which the lease of the Trufferie is granted to the Grower are contained in the Lease and Sub-lease Agreement. The Lessor grants to the Grower the non-exclusive right to use:

- (a) the irrigation for the purpose of cultivating the trees;

- (b) the right to draw water from any dams on the Land, or any other dam or water source to which the Lessor has access; and
- (c) all other infrastructure, plant and equipment available to, or owned by, the Lessor in or about the Land.

27. The Land Owner will be responsible for purchasing the Oak and Hazelnut trees, inoculating the trees with truffle and planting the trees on the Trufferie between 1 June 2006 and 15 June 2006. The Land Owner will plant sufficient trees to ensure there will be an average of at least 500 trees per hectare.

28. The Lease and Sub-lease for Growers Agreement entitles the Grower to the Truffles produced on the Grower's Trufferie (clause 2.4).

Project Operations Agreement

29. Each Grower enters into a Project Operations Agreement with the Responsible Entity, contracting the Responsible Entity to establish and manage the long term commercial cultivation of Truffle inoculated trees for the purpose of harvesting Truffles for sale.

30. The Responsible Entity agrees to carry out the following Initial Services during the Initial Period, being the period from the Commencement Date up to 30 June 2006, on behalf of the Grower:

- (a) testing of all Oak and Hazelnut trees for infection after planting by the Land Owner;
- (b) certifying the trees as having been inoculated and infected with black truffle after planting by the Land Owner;
- (c) vermin control; and
- (d) application of lime, herbicide and fertiliser to the Trufferies.

31. After the Initial Period, the Responsible Entity agrees to provide the following ongoing management services for the term of the Project:

- (a) design and supervise the installation by the Land Owner of a suitable irrigation system;
- (b) maintain the irrigation system installed by the Land Owner;
- (c) irrigate the Oak and Hazelnut trees on the Land;
- (d) testing of soils and Oak and Hazelnut tree roots to monitor soil elements and infection levels of the tree roots with the fungi;
- (e) maintain the Trufferies in a proper and skilful manner pursuant to the Trufferie Establishment and Maintenance Plan;

- (f) to tend to and cultivate the Oak and Hazelnut trees according to the principles of sound silvicultural practice, including the application of fertiliser and other chemicals, as the Manager deems appropriate to promote tree and truffle growth and yields;
- (g) to maintain fences erected on the Land by the Land Owner to prevent the entry of kangaroos and vermin, soil degradation and protect the placements of the Oak and Hazelnut trees;
- (h) to keep the Trufferies in good and substantial repair and condition and conduct activities on them in a commercial manner in keeping with accepted silviculture industry standards;
- (i) to promptly, and if immediate action cannot be taken, as soon as is practicable, repair all damage to roads and fences on the Trufferies which results from the performance by the Manager of its obligations pursuant to this Agreement;
- (j) to do such things as may reasonably be required to eradicate, exterminate and keep the Trufferies and the Land free from disease, vermin, noxious weeds, rabbits, kangaroos, insect pests and all other pests;
- (k) to keep the following insurance policies current with a reputable insurer:
 - (i) a public risk insurance policy in respect of the Trufferies at the Manager's cost; and
 - (ii) insurance on behalf of all Growers' Trufferies in relation to hail, fire, malicious damage, lightning and explosions for such period as is promised to the Grower under the Project Operations Agreement;
- (l) to maintain dams and water supply pumps to ensure the water supply is adequate at all times for Truffle Farming; and
- (m) to develop and continually monitor the Truffle Processing and Marketing Plan.

32. The Responsible Entity will send a report to the Grower no later than 31 July 2007 and by 31 July of each succeeding year summarising details of all truffles harvested in the preceding financial year and any other matters that may reasonably affect the Project.

Harvesting

33. Under the Project Operations Agreement, the Grower appoints the Responsible Entity to harvest the truffles produced on the Trufferie as and when deemed appropriate in keeping with sound truffle harvesting practices (clause 7).

34. The Responsible Entity will make all the arrangements for harvesting, freighting and making the truffles available for sale.

35. The Responsible Entity will pay for all harvest costs and will recover from the Grower a sum equal to 5.5% of the Grower's Gross proceeds (clause 7.4).

Truffle marketing and sale

36. The Grower authorises the Responsible Entity to market and sell the Truffles (clause 8). The Truffles from any Trufferie may be pooled with Truffles from any other Trufferie. The Responsible Entity will use its best endeavours to negotiate the sale of the Truffles for the highest price practicable having regard to the circumstances at the relevant time.

37. The Receipts from the sale of Truffles will be paid into the Trust Account held by the Bare Trustee. Receipts received by the Bare Trustee are to be distributed in the following order of priority:

- to pay to the Responsible Entity any outstanding fees and expenses payable by the Grower to the Responsible Entity under the Constitution;
- to pay to the Responsible Entity any outstanding fees, costs or interest owing by the Grower to the Manager under the Project Operations Agreement;
- to pay to the Owner any outstanding Rent or other fees, costs, interest or expenses owing by the Grower to the Owner under the Lease; and then
- to the Grower, provided that if the aggregate sum to be distributed is less than \$1,000, then at the discretion of the Responsible Entity, distribution to Growers may be postponed (clause 12 of the Constitution).

Marketing and Management Agreement

38. The Responsible Entity will enter into a Marketing and Management Agreement with Truffle Projects Pty Ltd (the 'Manager').

39. Under the Agreement, the Responsible Entity will sub-contract and engage the Manager to carryout the Responsible Entity's duties and obligations under the Project Operations Agreement.

Fees

40. Under the Project Operations Agreement and the Lease and Sub-lease for Growers Agreements, the Grower is required to pay the following:

- initial fees on application;
- annual Management Fees;
- harvesting and sales costs;
- annual Lease Fees; and
- incentive fee where there is an average yield across the entire project of 70kgs/ha.

Initial fees on application

41. Each Grower will be required to pay an initial Application Amount of \$16,449.60 on application. This amount is made up of:

- Management Fee of \$8,800;
- Lease Fee of \$633.60; and
- Shares subscription amount of \$7,016.

42. Under the PDS/Prospectus, a Grower can choose to pay the Application Money amount in full on the due date or pay the amount over a 12 month period under the Terms Payment Option offered by the Responsible Entity. Where the Responsible Entity accepts a Grower's application to pay their Application Money under the Terms Payment Option, the amount is payable as follows:

Deposit on Application: \$9,016 (\$2,000 per Trufferie and \$7,016 for the Land Shares);
and

Monthly Instalments: 12 equal monthly payments of \$664 per Trufferie (including interest).

The total amount paid under the Terms Payment Option includes interest and a Terms Application Fee of \$50.

Terms Agreement for 2006 Terms Growers

43. Growers who choose to pay under the Terms Payment Option must complete a Terms Application and Direct Debit Request. A Terms Agreement will be executed by the Responsible Entity.

44. The monthly instalments are paid by direct debit commencing on the last business day of July 2006.

45. If a Grower does not pay the required instalments under the Terms Payment Option, the balance of principal, interest and any additional costs payable under the Agreement becomes immediately due and payable to the Responsible Entity. In addition, the Responsible Entity may take legal action to recover the balance of principal and interest and any costs payable under this Agreement or any other legal action relating to this Agreement, take possession of the Growers Trufferie and do anything an owner of the secured property is entitled to do (clause 9.2 of the Terms Agreement).

Management Fees – Years 1 to 3

46. Management Fees are payable in each of the first three years of the Project for ongoing management services as follows:

- \$6,600, payable on or before 1 June 2007, for the period 1 July 2006 until 30 June 2007 (Year 1);
- \$4,180, payable on or before 1 June 2008, for the period 1 July 2007 until 30 June 2008 (Year 2); and
- \$2,640, payable on or before 1 June 2009, for the period 1 July 2008 until 30 June 2009 (Year 3).

Ongoing Management and Lease Fees

47. For the Financial Year 1 July 2009 to 30 June 2010 and each succeeding Financial Year until the expiry of the Lease Term, a Management Fee equal to the preceding Financial Year's Management Fee, indexed, is payable on or before 1 June of the relevant financial year.

48. For the Financial Year 1 July 2006 to 30 June 2007 and each succeeding Financial Year, a Grower is required to pay an amount of Rent equal to the amount paid for the previous Financial Year indexed. The Annual rent is payable in arrears on 1 June of each year for the term of the Project.

Harvesting Costs

49. Harvesting Costs will be deducted from the Grower's Proportion of the Gross Proceeds. The amount of the harvest costs will be equal to 5.5% of the Grower's Proportion of the Gross Proceeds.

50. The Responsible Entity is entitled to 50% of the Net Proceeds from the sale of Truffles that are attributable to the production in excess of 70kgs per hectare over the entire Project.

Shares

51. Each Grower must also subscribe for 3,508 shares in the Land Owner, Truffle Properties Limited, for each Trufferie. The cost of each share is \$2 and is payable on application.

Finance

52. Growers may fund their involvement in the Project themselves, enter into a Terms Payment Option with Watershed Premium Wines Ltd or borrow from an independent lender.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL of the ITAA 1936 or the funding arrangements transform the Project into a 'scheme' to which Part IVA of the ITAA 1936 may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project are involved or become involved in the provision of finance to Growers for the Project.

Ruling

Application of this Ruling

54. This Ruling applies only to Growers who are accepted to participate in the Project on or before 31 May 2006 and have executed a Project Operations Agreement and a Lease and Sub-lease Agreement by this date. A Grower's participation in the Project must constitute the carrying on of a business of primary production.

Minimum subscription

55. 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 Prospectus/PDS, a Grower's application will not be accepted, and the Project will not proceed, until the minimum subscription of 50 interests is achieved.

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

56. To be an 'STS taxpayer', a Grower must be eligible to be an 'STS taxpayer' and must have elected to be an 'STS taxpayer' (Division 328). For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different depending on whether the Grower who was an 'STS taxpayer' prior to 1 July 2005 continues to use the cash accounting method (called the 'STS accounting method') – see section 328-120 and 328-125 of the *Income Tax (Transitional Provisions) Act 1997*.

57. For such Growers, a reference in this ruling to an amount being deductible when 'incurred' will mean that amount is deductible when paid and a reference to an amount being included in assessable income when 'derived' will mean that amount is included in assessable income when received.

Qualification

58. 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.

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

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

Assessable income**Sections 6-5 and 328-105**

60. 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.

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

Deductions for Management Fees, Lease Fees and Interest**Sections 8-1 and 328-105**

62. A Grower may claim tax deductions under section 8-1 for the revenue expenses in the Table below on a per Trufferie basis.

Fee Type	ITAA 1997 Sections	Initial Year Year ended 30 June 2006	Year 1 Year ended 30 June 2007	Year 2 Year ended 30 June 2008
Management Fees	8-1	\$8,800 See Notes (i), (iii) & (v)	\$6,600 See Notes (i), (iii) & (v)	\$4,180 See Notes (i), (iii) & (v)
Lease Fees	8-1	See Notes (i), (ii), (iii) & (v)	\$633.60 (indexed) See Notes (i), (iii) & (v)	\$633.60 (indexed) See Notes (i), (iii) & (v)
Interest on Terms Payment Option	8-1	See Notes (i), (iv) & (v)	See Notes (i), (iv) & (v)	See Notes (i), (iv) & (v)

Notes:

- (i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (for example input tax credits): Division 27.
- (ii) In the initial year, the deduction for Rent is \$52.80 for each month the Grower leases the land. See paragraphs 91 and 92.
- (iii) Where a Grower pays the Management Fee and the deductible portion of the Lease Fee in the relevant income years shown in the Project Operations Agreement and Lease and Sub-Lease Agreement, those fees are deductible in full in the year that they are incurred.

- (iv) Interest payable under the Terms Payment Option will be deductible in the year that it is incurred.
- (v) 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 99 unless the expenditure is 'excluded expenditure'.

Shares

63. The shares in Truffle Properties Limited are CGT assets (section 108-5) and the amounts paid by a Grower to acquire the shares are an outgoing of capital and not allowable as a deduction.

64. The amounts paid for each share will represent the first element of the cost base of the share (subsection 110-25(2)). Any disposal of the shares by a Grower will be a CGT event and may give rise to a capital gain or loss.

Terms Application Fee

65. Growers who elect to pay the Initial fee under the Terms Payment Option must pay a Terms Application Fee of \$50.00. This amount is not deductible under section 8-1.

Tax outcomes that apply to all Growers

Interest

66. The deductibility or otherwise of interest arising from loan agreements entered into by financiers other than Watershed Premium Wines Ltd in relation to the Terms Payment Option 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 rule in paragraphs 93 to 100 as these 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.

Trading stock**Section 70-35**

67. A Grower who is not an 'STS taxpayer' will, in some years, hold truffles that will constitute trading stock on hand. Where, in an income year, the value of trading stock on hand at the end of an income year exceeds the value of trading stock on hand at the start of an income year a Grower must include the amount of that excess in assessable income.

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

Section 328-285

69. A Grower who is an 'STS taxpayer' may, in some years, hold truffles that will constitute trading stock on hand. Where, for such a Grower, for an income year, the difference between the value of all their trading stock at the start and a reasonable estimate of it at the end, is less than \$5,000, they do not have to account for that difference under the ordinary trading stock rules in Division 70 (subsection 328-285(1)).

70. Alternatively, a Grower who is an 'STS taxpayer' may instead choose to account for trading stock in an income year under the provisions of Division 70 (subsection 328-285(2)).

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

71. A Grower who is an individual accepted into the Project 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 the income years ending **30 June 2006 to 30 June 2013**. This conditional exercise of the discretion will allow those losses to be offset against the Grower's other assessable income in the income year in which the losses arise.

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

72. For a Grower who participates in the Project and incurs expenditure as required by the Project Operations Agreement and the Lease and Sub-lease Agreement the following provisions of the ITAA 1936 apply:

- expenditure by a Grower does not fall within the scope of sections 82KZME and 82KZMF (but see paragraphs 95 to 100);
- 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.

Commissioner of Taxation

22 March 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Is the Grower carrying on a business?

73. For the amounts set out in the Table above to constitute allowable deductions the Grower's horticulture activities as a participant in the Oak Valley Truffle Project must amount to the carrying on of a business of primary production. These horticulture activities will fall within the definitions of 'horticulture' and 'commercial horticulture' in section 40-535.

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

75. For schemes such as that of the Oak Valley Truffle 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.

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

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

77. In this Project, each Grower enters into a Project Operations Agreement and a Lease and Sub-lease Agreement.

78. Under the Lease and Sub-lease Agreement, each individual Grower will have rights over a specific and identifiable area of land. The Lease and Sub-lease Agreement provides the Grower with an ongoing interest in the specific Hazelnut and Oak Trees on the leased area for the term of the Project. Under the lease, the Grower must use the land in question for the purpose of carrying out horticultural activities and for no other purpose. The lease allows the Responsible Entity to come onto the land to carry out its obligations under the Project Operations Agreement.

79. Under the Project Operations Agreement, the Responsible Entity is engaged by the Grower to maintain a Trufferie(s) on the Grower's identifiable area of land during the term of the Project. The Responsible Entity has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to maintain the Trufferie on the Grower's behalf.

80. In maintaining the Trufferie(s), the Grower engages the Responsible Entity to maintain the Hazelnut and Oak trees on the Grower's Trufferie. The Responsible Entity is also engaged to harvest the truffles and sell, on the Grower's behalf, the truffles produced from the Grower's Trufferie.

81. 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.

82. 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 its truffles that will return a before-tax profit, which is a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

83. The pooling of truffles grown on the Grower's Trufferie with the truffles of other Growers is consistent with general horticulture practices. Each Grower's proportionate share of the sale proceeds of the pooled truffles will reflect the proportion of the truffles contributed from their Trufferie.

84. The Responsible Entity's services on the Grower's behalf are also consistent with general horticultural practices. The assets are of the type ordinarily used in carrying on a business of horticulture. While the size of a Trufferie is relatively small, it is of a size and scale to allow it to be commercially viable.

85. The Grower's degree of control over the Responsible Entity as evidenced by the Management Agreement, and supplemented by the *Corporations Act 2001*, is sufficient. During the term of the Project, the Responsible Entity will provide the Grower with regular progress reports on the Grower's Trufferie 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.

86. The horticulture 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 Growers' horticulture activities in the Oak Valley Truffle Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

87. 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.

88. 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 Management Fees, Lease Fees and Interest

Section 8-1

89. Consideration of whether the Management Fees, Lease Fees and Interest (the 'project fees') are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

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

90. The project fees associated with the horticulture activities will relate to the gaining of income from the Grower's business of horticulture, and hence have a sufficient connection to the operations by which income (from the regular sale of truffles) 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 fees is identifiable from the scheme. The project fees appear to be reasonable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

91. One of the exclusions under section 8-1 relates to expenditure which is capital, or capital in nature. Any part of the expenditure of a Grower entering into a horticulture business which is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and hence will not be deductible under section 8-1. The Commissioner is of the view that a portion of the Rent is capital expenditure and therefore the amount allowed as a deduction under section 8-1 will be reduced as follows.

92. A Grower who enters the Project on or before 31 May 2006 does not lease the land for a full income year in the initial year. As there is no reduction in the Rent in the initial year to reflect the actual period of the lease, it is considered that part of the Rent is a premium paid by the Grower for the grant of the lease and is capital in nature. Therefore, Growers will be entitled to a partial deduction of \$52.80, calculated on a pro-rata monthly basis, for each month that they lease the land in the initial year.

Prepayment provisions

Sections 82KZL to 82KZMF

93. 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.

94. For this Project only section 82KZL of the ITAA 1936 (an interpretative provision) and sections 82KZME and 82KZMF of the ITAA 1936 are relevant. Where the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes 'STS taxpayers' from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

95. Where the requirements of subsections 82KZME(2) and (3) of the ITAA 1936 are met, the formula in subsection 82KZMF(1) of the ITAA 1936 (see below) will apply to apportion expenditure that is otherwise deductible under section 8-1. 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)).

96. The requirements of subsection 82KZME(3) of the ITAA 1936 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.

97. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)) of the ITAA 1936. 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 scheme. The funds borrowed and the interest deduction is directly related to the activities under the scheme. If a Grower prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF of the ITAA 1936.

98. 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) of the ITAA 1936 is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1) of the ITAA 1936. However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the scheme that is less than \$1,000. Such expenditure is immediately deductible.

99. Where the requirements of section 82KZME of the ITAA 1936 are met, section 82KZMF of the ITAA 1936 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.

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

100. In the formula 'eligible service period' (defined in subsection 82KZL(1) of the ITAA 1936) 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

101. In this Project, an initial management fee of \$8,800 and rent of \$633.60 per Trufferie will be incurred on the execution of the Project Operations Agreement and the Lease and Sub-Lease Agreement. The management fee and rent are charged for providing management services or leasing of land to a Grower by 30 June of the year of the Project Operations Agreement and Lease and Sub-Lease Agreement coming into effect. Under these agreements, further annual expenditure is required each year during the term of the Project for the provision of management services and lease of land until 30 June in those years.

102. 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 scheme that the initial management fee has been inflated to result in reduced fees being payable for management fees in subsequent years.

103. There is also no evidence that might suggest the management services covered by the fee could not be provided within the relevant expenditure year. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial management fee, and the fees for subsequent years, is for the Project Manager doing 'things' that are not to be wholly done within the expenditure year. Under the Lease, rent is payable for the lease of the land during the expenditure year. The portion of the rent which is not in respect of the lease of the land is capital expenditure. See paragraphs 91 and 92.

104. On this basis, provided a Grower incurs expenditure as required under the Project agreements, as set out in paragraphs 41 to 48, then the basic precondition in subsection 82KZME(2) of the ITAA 1936 is not satisfied and, in these circumstances, section 82KZMF of the ITAA 1936 will have no application.

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

105. Although not required under either the Project Operations Agreement or the Lease and Sub-lease Agreement, a Grower participating in the Project may **choose** to prepay fees 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 104, section 82KZMF of the ITAA 1936 will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

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

107. 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 of the ITAA 1936.

Terms Application Fee

Section 8-1

108. Some Growers may finance their participation in the Project through a Terms Payment Option with Watershed Premium Wines Ltd. In doing so, they will incur a Terms Application Fee. Whether the resulting fee is deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of the initial fees.

109. One of the exclusions under section 8-1 relates to expenditure that is capital or capital in nature. Any part of the expenditure of a Grower that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, the Terms Application Fee is capital in nature. It is not deductible under section 8-1 or any other section of the Act.

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

110. The Commissioner has applied the principles set out in Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses in deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for the income years ending **30 June 2006 to 30 June 2013**.

111. Accordingly, based on the evidence supplied, the Commissioner has determined that for those income years ended 30 June 2006 up to and including 30 June 2013:

- it is because of its nature the business activity of a Grower that will not satisfy one of the four tests in Division 35;
- there is an objective expectation that within a period that is commercially viable for the viticulture 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.

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

Section 82KL – recouped expenditure

113. The operation of section 82KL of the ITAA 1936 depends, among other things, on the identification of a certain quantum of 'additional benefits(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA – general tax avoidance provisions

114. For Part IVA of the ITAA 1936 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).

115. The Oak Valley Truffle Project will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraph 62 that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

116. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of their truffles. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing at arm's length or, if any parties are not dealing at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) of the ITAA 1936, it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

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

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- horticulture
- management fees expenses
- non-commercial losses
- primary production
- primary production expenses
- primary production income
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- tax administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- TAA 1953
- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
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- ITAA 1936 82KZMB
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ATO references:

NO: 2006/4281

ISSN: 1441-1172

ATOlaw topic: Income Tax ~~ Product ~~ crops - other