



PR 2006/90 - Income tax: Mort Feedlot Services Project - Early Producers

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Product Ruling

Income tax: Mort Feedlot Services Project – Early Producers

Contents Para

BINDING SECTION:

What this Ruling is about 1

Date of effect 12

Withdrawal 16

Scheme 17

Ruling 67

NON BINDING SECTION:

Appendix 1:

Explanation 82

Appendix 2:

Detailed contents list 122

❗ This publication 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 Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates. In this Ruling this scheme is referred to as the 'Mort Feedlot Services Project – Early Producers' or simply as 'the Project'.

Relevant provision(s)

2. The relevant 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;
- section 25-25 of the ITAA 1997;
- Division 27 of the ITAA 1997;
- Division 35 of the ITAA 1997;
- Subdivision 61-J of the ITAA 1997;
- Division 70 of the ITAA 1997;
- Division 328 of the ITAA 1997;
- Division 328 of the *Income Tax (Transitional Provisions) Act 1997*;
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL of the ITAA 1936;
- section 82KZME and 82KZMF of the ITAA 1936;
- Division 3 of Part III 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 (referred to in this Ruling as a 'Producer') to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered or required to be registered for GST and hold a valid tax invoice.

Changes in the Law

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 Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

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

Note to promoters and advisers

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

Class of entities

7. The class of entities to whom this Ruling applies is the entities more specifically identified in the Ruling part of this Product Ruling and 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 as set out in the description of the scheme. In this Ruling, these entities are referred to as 'Producers'.

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

- entities 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;
- entities who enter into this scheme on or after 16 June 2006 and on or before 30 June 2006;
- entities who are accepted to participate in the Project during the period on or after 1 July 2006 and on or before 15 June 2007, being Late Producers to whom Product Ruling PR 2006/91 applies;
- entities who are accepted to participate in the Project during the period on or after 1 July 2007; and
- persons who participate in the Project through offers made other than through the Information Memorandum.

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 17 to 66.

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 24 May 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. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

13. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

14. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

15. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Withdrawal

16. This Product Ruling is withdrawn and ceases to have effect after 30 June 2009. The Ruling continues to apply, in respect of the relevant provisions ruled upon, to all entities within the specified class who enter into the scheme specified below. Thus, the Ruling continues to apply to those entities, 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 entity's involvement in the scheme.

Scheme

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

- Application for a Product Ruling dated 21 February 2006 as constituted by documents received on 21 February 2006, 14 March 2006, 11 April 2006, 3, 8 and 11 May 2006;
- Draft Information Memorandum for the 'Mort Feedlot Services Project' ('IM'), undated, received on 11 May 2006;
- Constitution of Mort & Co Limited, received on 21 February 2006;
- Draft **Farm Management Agreement** between Mort & Co Limited ('Mort' or the 'Manager') and the Producer, undated, received on 11 May 2006;
- Draft **Stock Mortgage Agreement** between the Manager and the Producer, undated, received on 21 February 2006; and
- Draft Custom cattle Feeding Agreement between the Manager and the Feedlot Operator, undated, received on 8 May 2006.

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

18. The documents highlighted are those that Producers may enter into. For the purposes of describing the scheme to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Producer, or any associate of a Producer, will be a party to, which are a part of the scheme. In this Ruling the term 'associate' has the meaning given by section 318 of the ITAA 1936.

19. In accordance with the above documents, a Producer who participates in the scheme must be a wholesale client. **This Ruling does not apply unless the Investor is a wholesale client for the purposes of section 761G of the *Corporations Act 2001*.** The meaning of wholesale client is explained in the Information Memorandum for this Project.

20. 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

21. The salient features of the Mort Feedlot Services Project – Early Producers are as follows:

Location	Existing feedlot facilities in Northern NSW and the Darling Downs region of Queensland
Type of business to be carried on by each Producer	The purchase, lot feeding and sale of beef cattle
Number of Herds offered under the project	There are no minimum or maximum number of Herds
Size of each Herd	1,000 head of beef cattle
No of Lots per Herd	10 Lots
Number of beef cattle per Lot	Approximately 100
Minimum allocation	1 Herd
Term of the Project	Between 3 to 5 years depending on purchase/sale cycle
Initial cost per Herd	Initial Management Fee of \$51,526 (which includes a \$600 loan establishment fee) plus costs of purchasing first Lot as determined by the market

Ongoing costs	Feedlot expenses, including feed, veterinary, transport and sale costs Management Fees of \$27.50 per head of cattle Interest and finance costs Performance Fee
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22. Applicants that are accepted to participate in the Project will carry on the business of acquiring, fattening and selling beef cattle. Each applicant will subscribe to a minimum of one Herd. Each Herd will consist of 1,000 head of cattle. The cattle will be acquired throughout the life of the project in Lots of approximately 100 hundred head per Lot. Producers with an interest in a single Herd will only hold a single Lot at any time. The cattle will be placed in existing feedlot facilities in northern NSW or the Darling Downs area of Queensland. Each Lot will be kept in the feedlot for a period between 100 and 125 days.

23. There is no minimum or maximum subscription for the Project. The Producer's Herd will be acquired and sold in the period between 3 and 5 years from the date of acceptance into the Project.

24. Producers accepted to participate in the Project will enter a Management Agreement with Mort & Co Limited who will act as Manager for the project. The Manager will acquire the cattle on behalf of the Producer, enter into agreements with the feedlot operators and arrange for the sale of the cattle at the end of the feedlot process. Producers will utilise a Secured Rolling Facility (the 'Facility') provided by the Manager for the purchase of each Lot. The Producer will grant the Manager a stock mortgage over each Lot of cattle as security for the Facility.

Information Memorandum

25. Mort & Co Limited are offering interests in the Project via the Information Memorandum ('IM') for the Mort Feedlot Services Project. Mort & Co Limited are holders of Australian Financial Services Licence Number 228989. Offers under the IM are strictly limited to persons who are 'wholesale clients' for the purposes of the Corporations Act. The IM is not required to be lodged with the Australian Securities and Investments Commission.

26. Applications to participate in the Project must be made on the application form contained in the IM.

27. There is no minimum or maximum number of Herds available under the IM. Producers will be invited to invest in at least one Herd comprising 1,000 head of beef cattle.

28. Producers who are accepted into the Project will enter into a Management Agreement and Stock Mortgage Agreement with the Manager in relation to the lot feeding arrangements. At the time of acceptance the Manager will commence the process of acquiring the Producer's first Lot. The Manager will be responsible for arranging the acquisition, lot feeding and negotiating the sale of each Lot.

29. Producers accepted on or before 15 June 2006, will commence participation as 'Early Producers'. **This Ruling only applies in respect of 'Early Producers' who are accepted into the Project from the date this Product Ruling issued to 15 June 2006. Note that a separate Product Ruling PR 2006/91 has issued for 'Late Producers' who are accepted into the Project from 1 July 2006 to 15 June 2007.**

Management Agreement

30. The Producer will enter into a Management Agreement with Mort & Co Limited (the 'Manager') where the Producer undertakes to conduct a business of backgrounding and feedlotting cattle and the Manager undertakes to provide certain services and financial accommodation in order to assist the operation of the Producer's business.

31. The Manager will provide Management Services to the Producer for the Herd. The services will only be provided in respect of one Lot at a time (clause 4.1). A Herd is defined as 1,000 head of cattle and a Lot as approximately 100 head (clause 1.1). The total number of cattle across all Lots will be equal to the Herd size.

32. Clause 4.2 specifies that the parties agree that the business will be conducted as follows:

- (a) the Manager will source and acquire the Lot with the cost of acquisition to be funded through a finance facility provided by the Manager and retained earnings generated from the Producers business, where available;
- (b) the Manager will manage the Lot through the backgrounding and feedlot process;
- (c) the Manager will arrange the sale of the Lot;
- (d) the Manager will finance, with the Producer ultimately being responsible for, costs associated with the purchase, transportation, feeding and sale of the Producer's cattle;
- (e) proceeds from the sale of each Lot will be, after repayment of the loan funds, payment of management fees, costs, interest and expenses associated with the Lot will be applied to the acquisition of another Lot; and
- (f) if sufficient funds have been generated a portion will be distributed periodically to the Producer.

33. The process in clause 4.2 will be repeated until the entire Herd has been acquired and sold or the Management Agreement is terminated. The balance of proceeds will be distributed to the Producer following the sale of the Final Lot and payment of any amounts owing by the Producer (clause 4.3).

34. It is intended that the Management Services will be provided in respect of up to 3 Lots each full financial year until the completion of the agreement. However the Manager reserves the right not to acquire a Lot at a particular time having regard to market conditions and other factors. The Producer may direct the Manager to acquire and manage a Lot against the recommendation of the Manager. In these circumstances the Manager will be required to acquire a Lot, however the Manager is under no obligation to provide a financial accommodation to facilitate the purchase of such a Lot (clause 4.5).

35. The Producer may make recommendations and give directions to the Manager in respect of the provision of Management Services. The Manager must consider the recommendations but is not under an obligation to act on those recommendations or directions (clause 5.4).

36. The Manager may delegate some or all of its functions under the Management Agreement. Delegation of functions does not release the Manager from liability under the Agreement (clause 5.5).

37. The Initial Management Fee (clause 6) is payable in respect of the following Initial Management Services:

- (a) establishing the processes and systems to facilitate the operation of the Producer's Business by the Manager;
- (b) establishing an integrated beef cattle supply and production process to enable to efficient production of prime lot fed cattle through the use of numerous production facilities to supply various premium beef markets;
- (c) establishing internal management operating systems to manage cattle procurement on behalf of the Producer in all eastern States of Australia;
- (d) establishing rations and feeding systems with custom lot feeders to ensure high feedlot conversion performance is achieved for the Producer's cattle;
- (e) establishing the 'Cowman' Lot based financial management system to enable consistent reporting of cattle under management at various production facilities;
- (f) establishing operating procedures and the legal framework for the Producer's Business to enable an actively managed lot feeding business to be undertaken;

- (g) engaging specialist management and operating personnel to enable physical assessment and handling of cattle located both in Feedlots and on Backgrounding properties;
- (h) establishing a Producer's account which the Manager will utilise to record the costs of lot feeding, transporting and managing the Producer's cattle. The Manager will subsequently be paid those costs from the Gross Sales Proceeds or, if insufficient, from the Producer;
- (i) legal and accounting expenses relating to development and establishment of the Producers' Business;
- (j) engaging consultants to assist in development of the Producer's Business;
- (k) establishing formal arrangements with major beef processing customers to ensure production and supply systems fit with takeoff expectations in respect of cattle specifications, feeding methods and supplying information;
- (l) establishing the Facility, which will be used to assist funding the acquisition of the Producer's Herd for the duration of this Agreement;
- (m) establishing an account into which Gross Sales Proceeds are deposited and monies payable under this Agreement are deducted;
- (n) establishing processes to enable timely management and reporting in accordance with the requirements of this Agreement;
- (o) assessing short and medium term market conditions and developing marketing (procurement, production and sale) protocols for the Producer's cattle;
- (p) negotiating supply arrangements with beef processors to assess price risk management options;
- (q) following establishment of marketing protocols, formulate ration the from available commodities to ensure efficient production is ensured given target market specifications;
- (r) inspecting and assessing the feedlot production facilities where the Manager intends to place the Producer's cattle; and
- (s) making arrangements to ensure insurance can be obtained for each Lot during the term of this Agreement in a timely and effective manner.

38. Once accepted into the Project the Producer is irrevocably committed to the Project and the Initial Management Fee is not refundable under any circumstances.

39. The Producer must pay the Manager the Initial Management Fee and reimburse the Manager the Costs and Expenses associated with the Lot. Specifically the Producer irrevocably authorises the Manager to pay the following amounts from the Gross Sales Proceeds:

- (i) Management Fee;
- (ii) Costs and Expenses;
- (iii) Interest;
- (iv) Finance Costs;
- (v) Taxes;
- (vi) all other costs and charges payable under the Agreement or the Stock Mortgage; and
- (vii) the Loan Principal,

in the order specified above (clause 8.2).

40. Costs and Expenses are defined as all costs, fees, charges, expenses and liabilities incurred by the Manager in providing the Management Services, including but not limited to freight costs, feed costs, induction fees and health costs, but excluding finance costs (clause 1.1).

41. The balance of funds from the Gross Sale Proceeds will be applied towards the acquisition of the next Lot with the remainder of funds to be drawn down from the Facility (clause 8.3).

42. Within 14 days of the end of each Financial Year the Manager must decide if the Producer's Annual Distribution is payable and, if so, distribute it to the Producer (clause 8.4). The Producer's Annual Distribution in respect of a Financial Year is defined as 25% of the Total Net Sales Proceeds, other than proceeds from the Final Lot (clause 1.1). The Producer acknowledges that the remaining 75% will be applied to the acquisition of future Lots and payment of fees and expenses in accordance with the Agreement.

43. In accordance with clause 8.5 and within 30 days of the sale of the Final Lot the Manager must:

- (i) calculate and deduct any Performance Fee payable;
- (ii) deduct from the Account any money owing to the manager; and
- (iii) where there is a Surplus in the Account, distribute the Surplus to the Producer; or
- (iv) where there is a Deficit in the Account, render an invoice to the Producer requiring payment of that Deficit.

44. In any event where Gross Sales Proceeds from a Lot are not sufficient to pay amounts due by a Producer the Manager may demand payment in writing. Where a demand has been made the Producer must pay the amount within 30 working days (clauses 8.6 and 8.7).

45. The Manager may choose not to demand payment but elect to recoup the shortfall from the Gross Sales Proceeds of a subsequent Lot (clause 8.8(a)). However, notwithstanding clause 8.8(a), the Producer must, within 90 days of the end of a Financial Year, pay in full any shortfall amounts owing on the last day of that Financial Year (clause 8.8(b)).

46. If there is a failure to make a payment (excluding Loan Principal) by the relevant due date the Manager will be entitled to recover compound interest at the rate of 12% per annum with interest accruing daily (clause 8.10).

47. The Manager may co-locate the Producer's cattle with another person's cattle provided that at all times the Producer's cattle and the Gross Sales Proceeds relating to the Producer's cattle are separately identifiable (clause 10).

48. The Producer owns all cattle acquired by the Manager on their behalf. The Manager must tag and lot number the Producer's cattle as soon as practicable after their purchase (clause 12).

Stock Mortgage

49. The Producer mortgages all its right title and interest to the Mortgaged Stock to the Manager as security for the Facility. The Producer will be responsible for all costs in relation to the Mortgage.

Custom cattle Feeding Agreement

50. The Manager will enter into a Custom cattle Feeding Agreement with a Feedlot Operator (the 'Feeder') for the purpose of feeding the Producer's cattle at the feedlot under the terms set out in the agreement. A Producer's cattle may be pooled with the cattle of other Producers when placed in the feedlot, however at all times the Producer's cattle will remain separately identifiable.

51. The cattle will be delivered by the Manager in individual consignments. The consignments will be grouped into commonly identified 'lots' upon induction into the Feedlot. The Feeder will implement additional identification procedures as requested by the Manager to enable the Manager to meet its obligations to separately identify each Producer's cattle (clause 2.2).

52. Cattle lots entering the feedlot over a predetermined time period and comprising a predetermined number of cattle are referred to as a Cattle Batch (clause 2.3).

53. The terms and conditions for the custom feeding are as contained in the agreement and the corresponding cattle Feeding Schedule.

54. Clause 2.5 requires the cattle Feeding Schedule to specify:
- (a) maximum and minimum number of cattle that will comprise a Cattle Batch;
 - (b) the maximum and minimum number that will be on feed through the specified Cattle Intake Period;
 - (c) the date range over which the Cattle Batch will enter the feedlot;
 - (d) the maximum number of days for which the Cattle Batch will be fed;
 - (e) ration and induction charge out rates for individual cattle Batches for the time the Cattle Batch will be in the feedlot; and
 - (f) the ration makeup, dry matter and energy content of the ration to be fed to the Cattle Batch.
55. The Manager or the Producer may enter the feedlot at any time without notice and in the presence of the Feeder to ensure that the Feeder is complying with their obligations under the agreement or to check stock numbers (clause 3.1).
56. The Manager will, on behalf of the Producer, be responsible for the delivery to and removal of the cattle from the feedlot, including all the necessary documentation and identification in relation to the cattle. The cattle will be weighed on a registered weighbridge on entry to and exit from the feedlot.
57. Clause 5.6 states that the Feeder will be responsible for:
- (a) provision of minimum space in the normal feed pens;
 - (b) provision of feedlot bunk space;
 - (c) provision of feed and water to at least the standard required by the National Feedlot Accreditation Scheme ('NFAS');
 - (d) daily monitoring of the health and welfare of the cattle and taking steps as necessary to maintain such health and well being such as the provision of medicines or veterinary services; and
 - (e) monthly monitoring chemical residue state of feed ensuring that it meets the minimum standard determined by NFAS.
58. The Producer at all times remains the owner of the cattle. The Producer will bear the risk of the mortality and morbidity of the cattle and any adverse climatic effect on the cattle except in the event of the Feeder breaching their responsibilities under the agreement. In the event of Feeder Breach the Feeder will pay the Manager the inventory value of the animal at the time of death (clause 6).
59. Clause 7 of the agreement details the fees and charges to be levied under the agreement. The charges levied will be consistent with industry standards and prevailing market conditions.

Project Fees

60. Upon application a Producer is required to pay an Initial Management Fee of \$51,526. The Initial Management Fee includes \$600 which relates to the establishment of the Producer's Facility under the arrangement.

61. Following the sale of each Lot a Producer will pay a \$27.50 per head Management Fee and all Costs and Expenses relating to the Lot. After the sale of the Final Lot the Manager will be entitled to a Performance Fee equal to 50% of the amount by which the Earnings exceeds the Benchmark Return. Earnings is defined as the Gross Sales Proceeds for the Final Lot and all preceding Lots less the Shortfall for any Lot and Management Fees, Costs and Expenses, Interest, Taxes, Finance Costs and acquisition costs for the Total Lots. The Benchmark Return is an internal rate of return of 12%.

Finance

62. In accordance with clause 20 of the Management Agreement the Manager will provide to the Producer access to a Facility on the following terms and conditions:

- (a) the Facility may only be used for the purchase of Lots in the Project; and
- (b) in return the Producer must grant in favour of the Manager a mortgage over the Lot.

63. Interest will accrue daily on the Loan Principal and will be payable in accordance with clause 8 of the Management Agreement. Interest will be at the official cash rate as set by the Reserve Bank plus a margin of 3.5% per annum.

64. The Manager will only drawdown the Facility for the purpose of acquiring a Lot. When a Lot is sold the loan principal and interest is repaid from the Gross Sale Proceeds. The Producer is required to make up any shortfall that might arise in accordance with the Management Agreement (see paragraphs 44 and 45).

65. There will be no finance offered by the Manager or any related entity in relation to a Producer's Initial Management Fee.

66. This Ruling also does not apply if the finance scheme entered into by the Producer with the Manager or any other lender 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 schemes or other collateral agreements in relation to the loan designed to limit the borrower's risk;

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

Ruling

Application of this Ruling

67. This Ruling applies only to Producers who:

- are accepted to participate in the Project on or before 15 June 2006;
- have executed a Management Agreement by that date; and
- are a wholesale clients (as defined in section 761G of the Corporations Act).

68. This Ruling does not apply to Producers who:

- intend to terminate their involvement in the arrangements prior to its completion, or who otherwise do not intend to derive assessable income from it;
- enter into finance arrangements with entities associated with this Project, other than those specified in paragraphs 62 to 66; or
- enter the Project after 15 June 2006.

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

70. A Producer is not eligible to claim any tax deductions until the Producer's application to enter the Project is accepted and the Project has commenced.

The Simplified Tax System (STS)

Division 328

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

72. For such Producers, 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.

25% entrepreneurs tax offset

Subdivision 61-J

73. 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

Section 6-5

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

Trading stock

Section 70-35

75. A Producer who is not an 'STS taxpayer' may, in some years, hold cattle 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 Producer must include the amount of that excess in assessable income (subsection 70-35(2)).

76. 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 Producer may claim the amount of that excess as an allowable deduction (subsection 70-35(3)).

Section 328-285

77. A Producer who is an 'STS taxpayer' may, in some years, hold cattle that will constitute trading stock on hand. Where, for such a Producer, 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)).

78. Alternatively, a Producer 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)).

Deduction for Initial Management Fee

Sections 8-1 & 25-25

79. A Producer may claim tax deductions for the expenses listed in the Table below:

Fee Type	Year ended 30 June 2006	Year ended 30 June 2007	Year ended 30 June 2008
Initial Management Fee	\$50,926 See Note (i)		
Management Fee		Must be calculated See Notes (i) & (ii)	Must be calculated See Notes (i) & (ii)
Costs and Expenses		Must be calculated See Notes (i) & (ii)	Must be calculated See Notes (i) & (ii)
Interest		As incurred See Note (iii)	As incurred See Note (iii)
Borrowing costs	Must be calculated See Note (iv)	Must be calculated See Note (iv)	Must be calculated See Note (iv)

Notes:

- (i) If the Producer is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST: Division 27.
- (ii) The amount of the deduction allowable will be the costs incurred and will depend upon the number of Lots sold by the Producer during the year of income.
- (iii) Interest under the Facility with the Manager as described at paragraph 62 to 66 is deductible. The deductibility or otherwise of interest arising from loan agreements entered into with financiers other than the Manager or in respect of the Initial Management Fee is outside the scope of this Ruling. However all Producers should read the discussion of the prepayment rules in paragraphs 104 to 111 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 Producer's choice.
- (iv) The Initial Management Fee incorporates \$600 for the establishment of the Facility. This amount is a borrowing cost and is deductible under section 25-25. It is incurred for borrowing moneys that are used or are to be used during that income year solely for income producing purposes. The deduction is spread over the period of the loan or 5 years, whichever is the shorter. The deductibility or otherwise of borrowing costs arising from loan agreements other than for the Facility is outside the scope of this Ruling.

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

Section 35-55 – exercise of Commissioner's discretion

80. A Producer who is an individual accepted into the Project by 15 June 2006 may have a loss 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 Producers for the income year ending **30 June 2006**. This conditional exercise of the discretion will allow the loss to be offset against the Producer's other assessable income in the income year in which the losses arise.

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

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

- expenditure by a Producer does not fall within the scope of sections 82KZME and 82KZMF (but see paragraphs 106 to 111);
- 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 Taxation24 May 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 Producer carrying on a business?

82. For the amounts set out in the Table above to constitute allowable deductions the Producer's feedlotting and cattle selling activities as a participant in the Mort Feedlot Services Project – Early Producers must amount to the carrying on of a business of primary production.

83. Where there is a business, or a future business, the gross proceeds from the sale of the cattle 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.

84. For schemes such as that of the Mort Feedlot Services Project – Early Producers, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Producer's activities can constitute the carrying on of a business. As 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.

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

- the Producer has an identifiable interest the cattle held for feedlotting and sale purposes;
- the Producer has a right to take and sell the cattle;
- the feedlotting and sale of the cattle are carried out on the Producer's behalf;
- the activities of the Producer are typical of those associated with a business of feedlotting and sale of cattle; and
- the weight and influence of general indicators point to the carrying on of a business.

86. In this Project, each Producer enters into a Management Agreement.

87. Under the Management Agreement, each individual Producer will acquire a Herd consisting of 1,000 cattle to be acquired in Lots of approximately 100 head. The cattle will be fattened in a feedlot and then sold.

88. The Management Agreement acknowledges that the Producer is the absolute owner of the cattle. Although the Producer's cattle may be pooled with that of another Producer during the feedlotting and sale process, the Producer's cattle will be tagged and readily identifiable at all times. The Producer will be entitled to the Gross Sales Proceeds derived directly from the sale of their cattle only.

89. Under the Management Agreement Mort is engaged by the Producer to acquire the Herd, supervise the feedlot process and arrange the sale of the Herd. Mort will enter into feedlot agreements for the placement and fattening of the Producer's Herd in Lots throughout the period of the project. Mort has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to maintain the cattle on the Producer's behalf.

90. 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.

91. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Producer in the Project will derive assessable income from the sale of cattle 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.

92. The pooling of the Producer's cattle with cattle of other Producers at the feedlot and sale is not inconsistent with general pastoral practices. The Producer's share of the sale proceeds will be from their cattle only and will not be affected by the number or quality of other Producer's cattle.

93. Mort's services are also consistent with general pastoral practices. They are of the type ordinarily found in pastoral ventures that would commonly be said to be businesses. While the size of a 'Herd' is relatively small, it is of a size and scale to allow it to be commercially viable (see Taxation Ruling IT 360).

94. The Producer's degree of control over Mort as evidenced by the Management Agreement, and supplemented by the *Corporations Act 2001*, is sufficient. During the term of the Project, Mort will provide the Producer with regular progress reports on the Producer's Herd and the activities carried out on the Producer's behalf. Producers are able to terminate arrangements with Mort in certain instances, such as cases of default or neglect.

95. The activities of purchasing, feedlotting and selling cattle, and hence the fees associated with the process, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. For the purposes of this Ruling, the Producer's activities of feedlotting and selling beef cattle in the Mort Feedlot Services Project – Early Producers will constitute the carrying on of a business.

The Simplified Tax System

Division 328

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

97. The question of whether a Producer is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Producer 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 and Costs and Expenses

Section 8-1 & 25-25

98. Consideration of whether the fees payable under the Management Agreement 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.

99. Any part of the expenditure of a Producer entering into a pastoral business 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, \$600 of the Initial Management Fee, representing the costs of establishing the Producer's Secured Rolling Facility, are a borrowing expense and considered to be capital and therefore not deductible under section 8-1. Borrowing expenses may be claimed as a deduction in accordance with section 25-25.

100. The fees payable under the Management Agreement are associated with the Producer's feedlotting and selling activities will relate to the gaining of income from the Producer's business, and hence have a sufficient connection to the operations by which income (from the sale of cattle) 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 arrangement. The fees appear to be reasonable and the fees have no capital component, other than the amount representing borrowing expenses discussed above. The tests of deductibility under the first limb of section 8-1 are met and the exclusions do not apply.

Interest deductibility

Section 8-1

(i) Secured Rolling Facility with Mort & Co Limited

101. Producers finance their acquisition of cattle in the Project through a loan facility with Mort & Co Limited. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of fees payable under the Management Agreement.

102. The interest incurred by Producers from the first drawdown and in subsequent years of income will be in respect of a facility to finance the Producer's business operations – the fattening and selling of beef cattle – that will continue to be directly connected with the gaining of 'business income' from the Project. Such interest will, therefore, have a sufficient connection with the gaining of assessable income to be deductible under section 8-1.

(ii) Producers who finance their Initial Management Fee

103. The deductibility of interest incurred by Producers who finance their participation in the Project through a loan facility with a bank or financier is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by the Tax Office.

Prepayment provisions***Sections 82KZL to 82KZMF***

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

105. For this Project, only section 82KZL of the ITAA 1936 (an interpretive 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 them from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

106. Other than expenditure deductible under section 82KZMG of the ITAA 1936, if 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 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

107. The requirements of subsection 82KZME(3) 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 scheme are managed by someone other than the taxpayer; and

- either:
 - a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

108. 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 Producer 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 resulting interest deduction are directly related to the activities under the scheme. If a Producer prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF of the ITAA 1936.

109. There are a number of exceptions to these rules, but for Producers 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 Producers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the scheme that is less than \$1,000. Such expenditure is immediately deductible.

110. 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.

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

111. 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

112. In this Project, an Initial Management Fee \$51,526, incurred on execution of the Management Agreement. The Initial Management Fee is charged for providing management services to a Producer by 30 June of the year of execution of the Agreements. Under the Agreement, further annual expenditure is required each year during the term of the Project for the provision of management services until 30 June in those years.

113. In particular, the Initial 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.

114. 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 Manager doing 'things' that are not to be wholly done within the expenditure year. Under the Agreement the Management Fee and Costs and Expenses are payable in arrears from the Gross Sales Proceeds for the sale of each Lot during the expenditure year.

115. On this basis, provided a Producer incurs expenditure as required under the Management Agreement, as set out in paragraphs 60 and 61, 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.

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

Section 35-55 – exercise of Commissioner's discretion

116. In deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for the income year 30 June 2006 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 the income year ended 30 June:

- it is because of its nature the business activity of a Producer 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 cattle industry, a Producer's business activity will satisfy one of the four tests set out in Division 35 or produce a taxation profit; and
- a Producer 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.

117. 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 Producer will need to apply for a private ruling on the application of section 35-55 to those changed circumstances.

Section 82KL – recouped expenditure

118. 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 of the ITAA 1997.

Part IVA – general tax avoidance provisions

119. 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).

120. Mort Feedlot Services Project – Early Producers will be a 'scheme'. A Producer will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 60 to 61 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.

121. Producers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the cherries. There are no facts that would suggest that Producers 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.

Appendix 2 – Detailed contents list

122. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Relevant provision(s)	2
Goods and Services Tax	3
Changes in the Law	4
Note to promoters and advisers	6
Class of entities	7
Qualifications	9
Date of effect	12
Withdrawal	16
Scheme	17
Overview	21
Information Memorandum	25
Management Agreement	30
Stock Mortgage	49
Custom cattle Feeding Agreement	50
Project Fees	60
Finance	62
Ruling	67
Application of this Ruling	67
The Simplified Tax System (STS)	71
<i>Division 328</i>	71
25% entrepreneurs tax offset	73
<i>Subdivision 61-J</i>	73
Assessable income	74
<i>Section 6-5</i>	74
Trading stock	75
<i>Section 70-35</i>	75
<i>Section 328-285</i>	77
Deduction for Initial Management Fee	79
<i>Sections 8-1 & 25-25</i>	79
Division 35 – deferral of losses from non-commercial business activities	80

<i>Section 35-55 – exercise of Commissioner’s discretion</i>	80
Sections 82KZME, 82KZMF and 82KL and Part IVA	81
Appendix 1 – Explanation	82
Is the Producer carrying on a business?	82
The Simplified Tax System	96
<i>Division 328</i>	96
Deductibility of Management Fees and Costs and Expenses	98
<i>Section 8-1 & 25-25</i>	98
Interest deductibility	101
<i>Section 8-1</i>	101
<i>(i) Secured Rolling Facility with Mort & Co Limited</i>	101
<i>(ii) Producers who finance their Initial Management Fee</i>	103
Prepayment provisions	104
<i>Sections 82KZL to 82KZMF</i>	104
<i>Sections 82KZME and 82KZMF</i>	106
Application of the prepayment provisions to this Project	112
Division 35 – deferral of losses from non-commercial business activities	116
<i>Section 35-55 – exercise of Commissioner’s discretion</i>	116
Section 82KL – recouped expenditure	118
Part IVA – general tax avoidance provisions	119
Appendix 2 – Detailed contents list	122

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/11; TR 98/22; TR 2000/8;
TR 2001/14; IT 360; PR 2006/91

Subject references:

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

Legislative references:

- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZME
- ITAA 1936 82KZME(2)
- ITAA 1936 82KZME(3)
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZME(7)
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- ITAA 1936 Pt IVA
- ITAA 1936 177A
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- ITAA 1997 70-35
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