

PR 1999/29 - Income tax: Margaret River Wine Business

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Product Ruling

Income tax: Margaret River Wine Business

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Preamble

The number, subject heading, and the What this Product Ruling is about (including Tax law(s), Class of persons and Qualifications sections), Date of effect, Withdrawal, Arrangement and Ruling parts of this document are a ‘public ruling’ in terms of Part IVAAA of the Taxation Administration Act 1953. Product Ruling PR 98/1 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

What this Product Ruling is about

1. This Ruling sets out the Commissioner’s opinion on the way in which the ‘tax law(s)’ identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Margaret River Wine Business offered by International Wine Marketing and Management Ltd (‘IWMM’), or just simply as ‘the Project’.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- section 6-5 (*Income Tax Assessment Act 1997* (‘ITAA1997’));
 - section 8-1 (ITAA 1997);
 - section 387-60 (ITAA 1997);
 - section 387-125 (ITAA 1997);
 - Part 2-25 (ITAA 1997);
 - section 82KL (*Income Tax Assessment Act 1936* (‘ITAA 1936’));
 - section 82KZM (ITAA 1936), and
 - Part IVA (ITAA 1936).

Class of persons

3. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.
4. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product and gives no assurance the prices charged for the product are reasonable, appropriate, or represent industry norms. A financial (or other) adviser should be consulted for such information.
6. The Commissioner rules on the precise arrangement identified in the Ruling.
7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 12 to 26) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:
 - the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
 - the Ruling will be withdrawn or modified.
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Date of effect

9. This Ruling applies prospectively from 19 May 1999, 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).

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

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 2002. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Product Ruling application received from the applicant dated 6 January 1999;
- The Margaret River Wine Business Prospectus, dated 6 April 1999;
- Draft copy of Management Agreement between International Wine Marketing and Management Ltd ('IWMM') (Manager), Margaret River Wine

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Production Ltd ('MRWP) (Lessor) and Each Several Person named (Member) (undated);

- Draft copy of Lease Agreement between each Grower and MRWP;
- Draft copy of Vineyard Maintenance Agreement between IWMM and Quenby Viticultural Services Pty Ltd (undated);
- Copy of the Margaret River Wine Business Constitution;
- Draft copy of Vineyard Establishment Agreement between MRWP and Quenby Viticultural Services Pty Ltd (undated);
- Draft copy of Wine Processing Agreement between IWMM as agent for each Grower and MRWP (undated); and
- additional correspondence received from the applicant dated 13 January 1999, 16 February 1999, 19 February 1999, 17 March 1999, 31 March 1999, 9 April 1999, 20 April 1999, 22 April 1999, 3 May 1999 and 4 May 1999.

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

13. For the purpose of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of the Grower, will be party to. The effect of these agreements is summarised as follows.

Overview

14. This arrangement is called the Margaret River Wine Business. The Project is to carry on a commercial viticulture and wine production business for a period of 18 years upon land in the vicinity of Mt Barker, Western Australia. Once harvested, the grapes will be manufactured under supervision by IWMM into bottled wine and then marketed, distributed and sold by IWMM on behalf of the Growers.

15. Growers entering into the Project will lease a fully irrigated and trellised vineyard from the Lessor. The minimum individual holding is one leased area of 0.0913 hectare. Overall, it is proposed that 120 hectares will be planted. The 1,315 leased areas this represents are identified on the plan of the vineyard attached to the

Lease and Management Agreement Growers may also subscribe for shares in Margaret River Wine Production Ltd.

Lease and Management Agreement

16. Under the Lease and Management Agreement a Grower makes payments to the Manager to:

- maintain and supervise all viticultural activities on the vineyard plots;
- purchase additional grapes to supplement Grape Produce;
- harvest and transport the grapes from the vineyard to the winery;
- process and store the grape produce;
- bottle and package;
- market the wine; and
- arrange distribution and sale of the bottled wine.

17. Growers execute a power of attorney enabling IWMM to act on their behalf in entering into the Wine Production Agreement with MRWP to manufacture the Growers' wine grapes into bottled wine, and enter into any agreements for the sale of the Growers' wine.

18. Growers enter into a Lease Agreement with MRWP as Lessor on or before 30 June 1999. Under the lease, MRWP is obliged to provide to the Growers a fully irrigated and trellised 0.0913 hectare vineyard lot. The Lease Agreement is conditional upon the Grower entering into the Management Agreement.

19. The Lessor grants the Grower a lease of a Leased Area (set out in the Schedule attached to the Lease and Management Agreement) and agrees at the Lessor's expense prior to Commencement Date to:

- commence the construction of trellising and irrigation;
- conduct soil and hydrology tests;
- deep fertilise the site; and
- undertake land preparation and site surveys.

20. The Lessor also agrees to do the following at the Lessor's expense after the Commencement Date:

- within 12 months complete the irrigation and trellising; and

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- within 3 months plant and establish suitable vine rootlings at a rate of 1,852 rootlings per hectare.

Fees

21. The Growers will make the following payments per Leased Area for the first year of operation:

- a management fee of \$19,537 to International Wine Marketing and Management Ltd for the management of the integrated wine business for the period 30 June 1999 to 30 June 2000;
- a lease fee of \$604 to Margaret River Wine Production Ltd for lease of the Grower's Leased Area of the vineyard for the period 30 June 1999 to 30 June 2000;

22. The Growers will make the following payments per Leased Area in the second year of operation:

- a management fee of \$8,092 to International Wine Marketing and Management Ltd for the management of the integrated wine business for the period 30 June 2000 to 30 June 2001;
- a lease fee of the \$604 charged in year 1, indexed annually to CPI, to Margaret River Wine Production Ltd for lease of the Grower's Leased Area of the vineyard for the period 30 June 2000 to 30 June 2001.

23. The Growers will make the following payments per leased area in the third year of operation:

- a management fee of \$6,922 to International Wine and Management Ltd for the management of the integrated wine business for the period 30 June 2001 to 30 June 2002;
- a lease fee of the \$604 charged in year 1, indexed annually to CPI, to Margaret River Wine Production Ltd for lease of the Grower's Leased Area of the vineyard for the period 30 June 2001 to 30 June 2002;

24. The Growers will make the following payments per leased area in the subsequent years 4 to 18 of operation:

- a management fee based on a cost plus contract where the Manager charges the Growers a proportionate amount of all the Manager's costs incurred in vineyard maintenance, product manufacturing and marketing and selling of the wine plus a fee of \$3 per case of wine sold on the Growers behalf; and

- a lease fee of the \$604 charged in year 1, indexed annually to CPI, to Margaret River Wine Production Ltd for lease of the Grower's Leased Area of the vineyard.

Finance

25. Growers can fund the investments themselves, borrow from an unassociated lending body or borrow through finance arrangements organised by the Manager. Finance arrangements organised directly by Growers are outside the arrangements to which this Ruling applies. The Manager has engaged the services of Laton Consolidated Pty Ltd ('Laton'), a company not associated with the Manager or any associated entities, to broker loans from nominated independent lenders, to cover the fees payable to the Manager. Apart from the arrangement with Laton, there is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Growers for any purpose associated with the Project.

26. The loans brokered by Laton will be on normal commercial terms of the particular lender; they will be both in form and substance, full recourse, and borrowers will be obliged to make regular repayments regardless of any income derived from the Project. The Manager will receive funds directly as a result of these loans, upon the Growers being accepted as borrowers. The Manager will not be placing any of these funds on deposit with Laton, the lender or any associated entities of Laton, the Manager or the lender, but will substantially use these funds in carrying out its obligations under the Management Agreement.

Ruling

27. For a Grower who invests in the Margaret River Wine Business the following deductions will be available:

- rent paid by the Grower in relation to the Leased Area will be an allowable deduction in the year incurred (section 8-1); and
- administration and management fees paid for the services outlined in the Lease and Management Agreement will be allowable deductions to the Grower in the year incurred (section 8-1).

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

Section 35-55 – Commissioner’s discretion

27.1. For a Grower who is an individual and who entered the Project on or after 19 May 1999 and prior to any withdrawal of this Product Ruling the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner has decided for the income year ended 30 June 2001 that the rule in section 35-10 does not apply to this business activity provided that the Project has been, and continues to be carried on in a manner that is not materially different to the arrangement described in this Ruling.

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

- a Grower’s business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the ‘Exception’ in subsection 35-10(4) applies.

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

27.4. Growers are reminded that they should not see the Commissioner’s decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from such a perspective has not been made.

Sections 82KZM, 82KL and Part IVA

28. For a Grower who invests in the Project the following provisions have application as indicated:

- the expenditure by Growers does not fall within the scope of section 82KZM;
- 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.

Explanations

Section 8-1: lease and management fees

29. It is appropriate, as a starting point, to consider whether lease and management fees are deductible under paragraph 8-1(1)(a). This consideration 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 outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income of the taxpayer.

30. A wine business can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from sales of bottled wine will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the tending, maintaining, harvesting, transporting, processing and bottling of the grapes and marketing and selling of the bottled wine.

31. Generally, a Grower will be carrying on a wine business where:

- the Grower has an identifiable interest in specific grape vines coupled with a right to harvest and sell the bottled wine produced;
- the business activities are carried out on the Grower's behalf; and

- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

32. Under the Lease and Management Agreement, Growers have rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of a commercial vineyard. Under the Lease and Management Agreement, Growers appoint the Manager to provide services such as maintaining the vines, harvesting the grapes, processing and selling the bottled wine. The agreement gives Growers full right, title and interest in the grapes produced and the right to have the grapes manufactured into wine and sold for their benefit.

33. The Lease and Management Agreement gives Growers an identifiable interest in specific vines and a legal interest in the land by virtue of a Lease.

34. Growers have the right to use the land in question for horticultural purposes and to have the Manager come onto the land to carry out its obligations under the Agreement. The Growers' degree of control over the Manager, as evidenced by the Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as substantial breach of obligations or insolvency.

35. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. The Independent Horticultural report considers that the Project is realistic and commercially viable. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

36. Growers will engage the professional services of a Manager with appropriate credentials. There is a means to identify which vines Growers have an interest in. The services are based on accepted viticultural and processing practices and are of the type ordinarily found in wine making activities that would commonly be said to be businesses.

37. The wine making activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The

Growers' wine making activities will constitute the carrying on of a business.

38. The management fees and rent associated with the wine making activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income (from the sale of bottled wine), is to be gained from this business. They will thus be deductible under the first paragraph of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under paragraph 8-1(1)(a) are met. The exclusions of subsection 8-1(2) do not apply.

Section 82KZM: prepaid expenditure

39. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

40. Under the Lease and Management Agreement the fee of \$20,141 per Leased Area will be incurred on execution of the Agreement. This fee is charged for providing services to a Grower only for the period of 13 months from the execution of the Agreement. For this Ruling's purposes, no explicit conclusion can be drawn from the arrangement's description that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is evidence this fee is for services to be provided within 13 months of incurring the expenditure in question.

41. Thus, for the purposes of this Ruling, it is accepted that no part of the fee of \$20,141 is for the Manager to do 'things' that are not to be wholly done within 13 months of the fee being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure by Growers of \$20,141 per area.

Section 82KL

42. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1), a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' plus the

‘expected tax saving’ in relation to that expenditure equals or exceeds the ‘eligible relevant expenditure’.

43. ‘Additional benefit’ (see the definition of ‘additional benefit’ at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The ‘expected tax saving’ is essentially the tax saved if a deduction is allowed for the relevant expenditure.

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

Part IVA: general tax avoidance provision

45. For Part IVA to apply there must be a ‘scheme’ (section 177A); a ‘tax benefit’ (section 177C); and a dominant purpose of entering into or carrying out the scheme to enable the relevant taxpayer to obtain a tax benefit in connection with the scheme (section 177D).

46. The Margaret River Wine Business will be a ‘scheme’. The Growers will obtain a ‘tax benefit’ from entering into the scheme, in the form of the tax deductions per Leased Area 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 enabling the relevant taxpayer to obtain this tax benefit.

47. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the bottled wine. Further, there are no features of the Project, such as the payment of excessive management fees and non-recourse loan financing by any entity, that might suggest the Project was so ‘tax driven’, and so designed to produce a tax deduction of a certain magnitude, that it would attract the operation of Part IVA.

Section 6-5: assessable income

48. Gross sale proceeds derived from the sale of bottled wine from the Project will be assessable income of the Growers, under section 6-5.

49. Once harvested, a Grower’s grapes will be trading stock of the Grower, as will any bottled wine. As a consequence, if grapes or grape juice or bottled wine are on hand at the end of the income year,

the Grower will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of the ITAA 1997.

50. Each Grower will be notified by IWMM of the respective amounts to be brought to account in proportion to their total holding in the Project, in accordance with Part 2-25 and Taxation Ruling IT 2001.

Detailed contents list

51. Below is a detailed contents list for this Ruling:

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Commissioner of Taxation

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Previous draft:

No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20;
TR 97/11; TR 97/16; TD 93/34;
IT 2001

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses
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- primary production
- primary production expenses
- producing assessable income
- product rulings
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- schemes and shams
- taxation administration
- tax avoidance
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- tax shelters
- tax shelters project

- ITAA1936 82KH(1F)(b)
- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 6-5
- ITAA1997 8-1
- ITAA1997 8-1(1)(a)
- ITAA1997 8-1(1)(b)
- ITAA1997 8-1(2)
- ITAA1997 Div 35
- ITAA1997 35-10
- ITAA1997 35-10(4)
- ITAA1997 35-30
- ITAA1997 35-35
- ITAA1997 35-40
- ITAA1997 35-45
- ITAA1997 35-55
- ITAA1997 35-55(1)
- ITAA1997 35-55(1)(b)
- ITAA1997 Pt 2-25
- ITAA1997 387-60
- ITAA1997 387-125
- TAA 1953 Pt IVAAA
- Copyright Act 1968

Legislative references:

- ITAA1936 82KH(1)

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