

PR 2000/114 - Income tax: Palandri Wine Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *29 November 2000*



Product Ruling

Income tax: Palandri Wine Project

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Potential investors may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

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 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

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

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

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

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

Terms of Use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Palandri Wine Project, 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* (ITAA 1997);
 - section 8-1 (ITAA 1997);
 - section 17-5 (ITAA 1997);
 - Division 27 (ITAA 1997);
 - Division 35 (ITAA 1997);
 - section 82KL *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KZM and 82KZMB - 82KZMD (ITAA 1936);
 - section 82KZME - 82KZMF (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

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

Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the *Ralph Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable.

Where tax laws change, those changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

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

Note to promoters and advisers

6. Product Rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date 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 'Members'.

8. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

9. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangements entered into are not the arrangements ruled upon; and
- the Ruling will be withdrawn or modified.

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reproduction and rights should be addressed to the Manager,
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Date of effect

11. This Ruling applies prospectively from 29 November 2000, the date the 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).

12. 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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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

- Application for Product Ruling dated 19 April 2000;
- The Margaret River Wine Business Project No.2 Prospectus, dated 21 June 2000;
- **Constitution for the Margaret River Wine Business Project No.2 between Palandri Wines Ltd [the 'Responsible Entity'], and the Member, undated;**

- **Lease and Management Agreement between Palandri Wines Ltd [the 'Responsible Entity'], Palandri Production Ltd [the Wine Production Company] and the Member, undated;**
- Wine Processing Agreement between Palandri Production Ltd and Palandri Wines Ltd;
- Vineyard Management and Maintenance Agreement between Palandri Wines Ltd and Quenby Viticultural Services Pty Ltd, undated;
- Vineyard Establishment Agreement between Palandri Production Ltd and Quenby Viticultural Services Pty Ltd, undated; and
- Additional correspondence dated 26 May 2000, 22 June 2000, 11 October 2000, 16 October 2000 and 6 November 2000.

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

15. The documents highlighted are those the Members enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Member, or any associate of the Member, will be a party to, with the exception of finance agreements, to which paragraphs 41 and 42 apply. The effect of these agreements is summarised as follows.

Overview

16. These arrangements are called the Palandri Wine Project.

Location	South West Region of Western Australia, 50 kms west of Mt Barker in the Frankland River wine region
Type of business each participant is carrying on	A commercial viticulture and wine production business for a period of 18 years
Number of hectares under cultivation	60 hectares
Name used to describe the product	Palandri Wine Project
Size of each Vineyard Lot	0.023 hectares
Number of vines per hectare	1852

Expected production	108,300 cases per annum
The term of the investment in years	18 years
Initial cost	\$11,000
Initial cost per hectare	\$478,260
Ongoing costs	Annual Management Fees and Rent

17. Members applying under the Prospectus dated 21 June 2000 enter into a Lease and Management Agreement. Palandri Production Ltd agrees to sub-lease to the Member an identifiable area of land called a 'Vineyard Lot', until the Project is terminated on 30 June 2018. Each Vineyard Lot is 0.023 hectares in size.

18. The Project Land is situated in the South West Region of Western Australia, approximately 50kms west of Mt Barker. Palandri Production Ltd holds a Head Lease over the land.

19. Palandri Production Ltd will sub-lease the Vineyard Lot to the Member for the purpose of Cultivating Vines and Harvesting Grapes. The vines must be planted by Palandri Production Ltd at the rate of 42 vines per Vineyard Lot either at the commencement date or within three months after the commencement date.

20. The Prospectus states that there is no minimum subscription for the Project. Each investor may subscribe for a minimum of one Vineyard Lot.

21. Possible projected returns for Members are outlined on pages 34 and 35 of the Prospectus. The projected returns are subject to the inherent risks of primary production and the commercial risks of a long term venture of establishing, growing and harvesting a commercial vineyard and the production, marketing and sale of wine. The risks associated with the Project have been outlined in the Prospectus. Based on the example set out on pages 34 and 35 of the Prospectus, a Member could expect to achieve an internal rate of return of 16.0% per Vineyard Lot. Members will execute a Power of Attorney enabling the Responsible Entity, Palandri Wines Ltd, to act on their behalf as required when they make an application for a Vineyard Lot.

22. The Prospectus expires on 31 December 2000 and interests in the Project will not be accepted after 31 December 2000.

Constitution

23. The draft Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Members and to manage the Project. The Responsible Entity will keep a register of Members. Members are entitled to assign their

Member's Interest in certain circumstances. As stated in paragraph 7 above, this ruling only applies to those Members who have a purpose of staying in the arrangement for the full term of the Project. The Lease and Management Agreement will be executed on behalf of a Member following them signing the Application and a Power of Attorney Form in the Prospectus. Members are bound by the Constitution and the Lease and Management Agreement by virtue of their participation in the Project.

Compliance Plan

24. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Its purpose is to ensure that the Responsible Entity meets its obligations as the Responsible Entity of the Project and that the rights of the Members are protected.

Interest in Land

25. A sub-lease is granted by the Head Lessor, Palandri Production Ltd, to the Members under the terms of the Lease and Management Agreement (cl.3.1). Members are granted an interest in land in the form of a sub-lease to use their Vineyard Lots for the purpose of cultivating Vines and Harvesting Grapes to produce, then market and distribute wine made from the grapes grown on their Vineyard Lot (Recital D). Members must pay rent to the Lessor of an amount of \$165 per Vineyard Lot per annum commencing on application and thereafter on 1 July of each year. This fee will be indexed annually. This amount includes GST. The term of a Member's lease is from the Commencement Date until 30 June 2018.

Lease and Management Agreement

26. Each Member enters into a Lease and Management Agreement with the Responsible Entity. The termination of the project is the date of completion of final harvest of the Grape Produce (Item 3 of Schedule). Members contract with the Responsible Entity to manage, maintain and harvest grapes from the vines and to produce and market wine made from the grapes on their behalf. Members pay a Management Fee of \$10,835 in Year One, \$4,642 in Year Two, \$4010 in Year Three and an amount annually thereafter which is the Member's proportion of the Management Costs (indexed) plus the Corporate Costs for performing the services under this agreement.

27. The Responsible Entity will carry out the following services under the agreement:

- maintain a trickle irrigation system to the Vines on the relevant Vineyard Lot;
- cultivate, tend, prune, fertilise, spray and otherwise care for the vines as and when required;
- use all reasonable measures to keep the relevant Vineyard Lot free from vermin, noxious weeds, pests and disease;
- at all times maintain the relevant Vineyard Lot and the Second Stage Vineyard Lot according to good viticultural practice;
- take all reasonable steps to prevent and manage land degradation on the relevant Vineyard Lot and to attend to the maintenance and management of the soil quality on the relevant Vineyard Lot;
- harvest the Vines on the relevant Vineyard Lot and deliver the Grape Produce to transport vehicles in accordance with good viticultural practice;
- purchase grapes and juice to supplement grapes grown on the relevant Vineyard Lot;
- arrange for the Wine to be bottled, corked and packaged and for the bottled wine to be placed in cartons;
- carry out the marketing strategy referred to in the Prospectus; and
- carry out the distribution and sales strategies referred to in the Prospectus.

28. The Responsible Entity will be responsible for paying the cost of public risk in respect of the Vineyard Lot and insurance against destruction or damage from usual risks in accordance with approved wine industry practices in respect of the grape produce and the wine (cl.20.1)

29. A Member can terminate the Lease and Management Agreement where there has been a breach (of a substantial nature) by the Responsible Entity which has not been remedied after written notice by the Member to do so or where the Responsible Entity commits an act of bankruptcy or goes or is placed into liquidation (cl.13.2)

30. The Responsible Entity will provide a report to Members on or before 31 July and 31 January each financial year containing a review of the operations of the Member's Wine Business during the relevant period (cl.17.1)

31. The Responsible Entity will tend to the Vines according to good viticultural practices. The services to be provided by the Responsible Entity over the term of the project are outlined in the Lease and Management Agreement (Item 11 of Schedule).

Harvesting

32. The Responsible Entity will be responsible for the harvesting of the grapes, and/or purchase of grapes and delivery of these grapes to the Winery and for production of Wine from those grapes and storage of the wine. Commencing from the date of the first commercially harvestable grape crop, or at such time or times as the Responsible Entity in its absolute discretion considers appropriate, the Responsible Entity will harvest or arrange for some other person to harvest the Grape Produce at such time or times as in the opinion of the Responsible Entity will result in Grape Produce suitable for the purposes of making quality wines.

33. The Receipts from the sale of Wine will be paid into the Proceeds Fund established by the Responsible Entity. Receipts received by the Responsible Entity are to be distributed in the following order of priority:

- Payment of any Annual Payments payable by the relevant Member;
- Payment of any other amounts payable by the relevant Member under the Lease and Management Agreement or any provision of the Constitution; and
- Distribution of the remainder to the relevant Member (cl.19.2 of the Lease and Management Agreement.).

Fees

34. The total Fee payable in the first year under the Lease and Management Agreement for the Project is \$11,000 per Vineyard Lot. This fee includes the Management Fee of \$10,835 and the Rent Fee of \$165 and is payable either in full on application or under a Time Payment Option. Under the Time Payment Option, a first instalment of \$2,200 is payable on application and monthly payments of not less than \$600 are payable each month with any outstanding balance of the Fees due and payable on 15 June 2001. The services to be carried out for these Fees will be commenced after the Member has been accepted into the Project and will be completed on or before 30 June 2001.

35. A Management Fee of \$4,642 is payable for services to be carried out in the period commencing 1 July 2001 until 30 June 2002 and is payable on 1 July 2001.

36. A Management Fee of \$4,010 is payable for services to be carried out in the period commencing 1 July 2002 until 30 June 2003 and is payable on 1 July 2002.

37. For the years from 1 July 2003 to 30 June 2018, Management Fees are payable by the Member each year for the Member's proportion of the estimated management costs (indexed by the Inflation Adjustment Factor for the Relevant Financial Year) plus the Member's proportional interest of the estimated Corporate Costs.

38. Rent of \$165 per year, indexed annually by the Inflation Adjustment Factor for the relevant Financial Year, is payable by the Member.

39. The Viticulturist Consultant has stated in the report, at pages 54 - 59 of the Prospectus, that with appropriate establishment procedures and sound management, this project can achieve its aims and objectives as outlined in the Prospectus.

40. The Application Monies will be held in the Trust Account by the Responsible Entity as Bare Trustee formed under the Project's Constitution (cl.12.1).

Finance

41. Members can fund their investment in the Project themselves, borrow from Palandri Finance Ltd (a lender associated with the Responsible Entity) or borrow from an independent lender.

42. This Ruling does not apply if a Member enters into a finance agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan 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 Palandri Finance Ltd are involved, or become involved, in the provision of finance to Members for the Project.

Ruling

Section 6-5 Assessable Income

43. A Member's share of the Gross sale proceeds derived from the sale of wine from the Project, less any GST payable on these proceeds, will be assessable income of the Member under section 6-5 of the ITAA 1997. Section 17-5 of the ITAA 1997 excludes from assessable income an amount relating to GST payable on a taxable supply.

Section 8-1

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

44. A Member may claim tax deductions in the Table below where they:

- participate in the Project to carry on the business of growing grapes and producing and marketing wine;
- incur the fees shown in paragraphs 34 - 38 by 30 June 2001; and
- are not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Year 1 30/6/2001	Year 2 30/6/2002	Year 3 30/6/2003
Management Fee	8-1	\$10,835	\$4,642 See note (i) below	\$4,010 See note (i) below
Lease Fee	8-1	\$165	\$165 See note (i) below	\$170 See note (i) below
Interest	8-1	See note (iii) below	See note (iii) below	See note (iii) below

Notes:

- (i) Where a Member incurs the management fees and the lease fees as required by the Lease and Management Agreement those fees are deductible in full in the year incurred. However, if a Member chooses to prepay fees for the doing of things (e.g., the provision of management services or the leasing of land) that will not be wholly done in the same income year as the fees are incurred, then the prepayment rules of the ITAA may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraphs 76 to 83 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being expenditure of less than \$1,000, is an 'exception' to any prepayment rules that apply and is deductible in full in the year in which it is incurred.
- (ii) The deductibility or otherwise of interest arising from agreements entered into with financiers other than Palandri Finance Pty Ltd (i.e., the internal financier) is outside the scope of this Ruling. However, all Members who finance their participation in the Project other than with Palandri Finance Pty Ltd should read carefully the discussion of the prepayment rules in paragraphs 62 to 64 below as those rules may be applicable if interest is prepaid.

Deductions where a Member is registered or is required to be registered for GST

45. Where a Member who is registered, or required to be registered, for GST:

- participates in the Project to carry on the business of growing grapes and producing and marketing wine;
- incurs the fees shown at paragraphs 34 - 38 by 30 June 2001; and
- is entitled to an input tax credit for the fees,

then the deductions will exclude any amounts of input tax credit (Division 27 of the ITAA 1997). See example 1 at paragraph 91.

Section 35-55 – losses from non-commercial business activities

46. For a Member who is an individual and who enters the Project during the year ended 30 June 2001 the rule in section 35-10 may apply to the business activity comprised by their involvement in this

Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2003 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

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

- a Member's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies (see paragraph 68 in the Explanations part of this ruling, below).

48. Where either the Grower's business activity satisfies one of the objective tests, the discretion in sub-section 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Member 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.

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

49. For a Member who invests in the Project and incurs expenditure in accordance with the Lease and Management Agreement, the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Member does not fall within the scope of section 82KZM (but see paragraphs 76 to 83);
- expenditure by the Member does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 76 to 83);
- expenditure by the Member does not fall within the scope of sections 82KZME – 82KZMF (but see paragraphs 76 to 83);
- 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 ITAA 1997

50. Consideration of whether lease and management fees are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

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

Is the Member carrying on a business?

51. A viticultural scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the sale of the grape produce and wine from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the grapes each year from the vines, and the production, marketing and sale of wine.

52. Generally, a Member will be carrying on a business of viticulture where:

- the Member has an identifiable interest in specific growing vines coupled with a right to harvest and sell the produce from the vines and the wine produced;
- the viticulture activities are carried out on the Member'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.

53. For this Project Members have, under the Lease and Management Agreement, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing grapes and the production, marketing and sale of wine. Under the Lease and Management Agreement, Growers appoint Palandri Wines Ltd, as Responsible Entity, to cultivate, tend, train, prune, fertilise, replant, spray and otherwise care for the grape vines as and when required consistent with Good Viticultural Practice and to use all reasonable measures to keep the Leased Area free from vermin, noxious weeds, pests and diseases. Members are considered to control their investment.

54. The Lease and Management Agreement provides Members with more than a chattel interest in the vines. The project documentation contemplates Members will have an ongoing interest in the vines.

55. Members have the right to use the land in question for viticulture purposes and wine production and to have the Responsible Entity come onto the land to carry out its obligation under the Lease and Management Agreement. The Members' degree of control over the Responsible Entity, as evidenced by the Lease and Management Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, Members are entitled to receive regular progress reports on the Project by Palandri Wines Ltd. Members are able to terminate arrangements with the Responsible Entity in certain instances, such as where there has been any substantial breach by the Responsible Entity of any material obligation under the Lease and Management Agreement or where the Responsible Entity has been placed in liquidation or official management. The viticultural activities described in the Lease and Management Agreement are carried out on the Members' behalf.

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

57. Members will engage the professional services of a manager with appropriate credentials. There is a means to identify which vines Members have an interest in. These services are based on accepted

viticultural practices and are of the type ordinarily found in viticultural ventures that would commonly be said to be businesses.

58. Members have a continuing interest in the vines from the time they are acquired until the cessation of the Project. The viticulture 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 Members' viticulture activities will constitute the carrying on of a business.

59. The lease and management fees associated with the viticulture activities and wine production 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 grape produce and wine) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. There is no capital component of the management fee. The tests of deductibility under section 8-1 are met. The exclusions do not apply.

Interest deductibility

(i) Members who use Palandri Finance Ltd as the finance provider

60. Some Members may finance their participation in the Project through a loan facility with Palandri Finance Ltd. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of lease and management fees.

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

(ii) Members who DO NOT use Palandri Finance Ltd as the finance provider

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

63. While the terms of any finance agreement entered into between relevant Members and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid for a period that is wholly or partly outside the income year in which the interest is incurred. Unless such prepaid interest is 'excluded expenditure', any tax deduction that may be allowable will be subject to the relevant prepayments provisions of the ITAA. 'Excluded expenditure' is an amount of expenditure of less than \$1,000.

64. The prepayments provisions are discussed in detail at paragraphs 76 to 83 of this Ruling. However, in broad terms, where interest is prepaid and the period to which the interest relates is wholly or partly outside the income year in which it is incurred, then any tax deduction that is allowable must be determined using the following formula;

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

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

Division 35 - losses from non-commercial business activities

65. Under the rule in subsection 35-10(2) a deduction for a loss incurred by an individual (including an individual in a general law partnership) from certain business activities will not be allowable in an income year unless:

- the 'Exception' in subsection 35-10(4) applies;
- one of four objective tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the objective tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

66. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

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

68. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary

production business activity and the individual taxpayer has other assessable income for the income year from sources not related to that activity of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Members who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

69. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year) (section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

70. A Member who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Member who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2005. Members who acquire more than one interest in the Project may, however, pass one of the tests in an earlier income year.

71. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Member's participation in the Project.

72. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Member who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the term of this Product Ruling.

73. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on; and

- (ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

74. This Product Ruling is issued on a prospective basis (i.e., before an individual Member's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 46), in the manner described in the Arrangement (see paragraphs 14 to 42), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

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

- the report of the independent viticulturist.

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

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

77. In this Project, the Management Fee of \$10,835 and Lease Fee of \$165 per Vineyard Lot will be incurred on execution of the Lease and Management Agreement. The Management Fee and the Lease Fee are charged for providing management services or leasing land to a Member by 30 June of the year of execution of the Agreement. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

78. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Member incurs expenditure as required by the agreements as set out in paragraph 34, then the basic precondition for

the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

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

79. Although not required under the Lease and Management Agreement, a Member participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 78 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

80. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Lease Fees otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means, generally, the period over which the services are to be provided. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Member is a 'small business taxpayer'.

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

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

In the formula, the 'eligible service period' means, generally, the period to which the services are to be provided.

82. Where a Member participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Member is a 'small business taxpayer' or section 82KZMD if the Member is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 84 to 86), the amount and timing of the allowable deductions will then be calculated using the formula in subsection 82KZM(1) and for non-small business taxpayers using the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 81 above concerning section 82KZMF.

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

Small business taxpayers

84. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

85. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

86. Whether a Member is a 'small business taxpayer' depends upon the circumstances of each Member and is beyond the scope of this Product Ruling. It is the responsibility of each Member to determine whether or not they are within the definition of a 'small business taxpayer'.

Section 82KL - recouped expenditure

87. The operation of section 82KL 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

88. For Part IVA to apply there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C) and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

89. The Palandri Wine Project will be a 'scheme'. A Member will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraph 44, 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.

90. Members 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 grapes. There are no facts that would suggest that Members 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 with each other at arm's length, or, if any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Example

Example 1 – entitlement to 'input tax credit'

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

$$1/11 \times \$5,500 = \$500$$

Therefore, the tax deduction for management fees that she can claim for the year ended 30 June 2001 is \$5,000 (\$5,500 *less* \$500).

Detailed contents list

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Commissioner of Taxation

29 November 2000

<i>Previous draft:</i>	- ITAA 1997 35-10(3)
Not previously issued in draft form	- ITAA 1997 35-10(4)
	- ITAA 1997 35-30
<i>Related Rulings/Determinations:</i>	- ITAA 1997 35-35
PR 1999/95; TR 92/1; TR 97/11;	- ITAA 1997 35-40
TR 97/16; TR 98/22; TD 93/34;	- ITAA 1997 35-45
IT 175; IT 2001	- ITAA 1997 35-55
	- ITAA 1997 35-55(1)
<i>Subject references:</i>	- ITAA 1997 35-55(1)(a)
- carrying on a business	- ITAA 1997 35-55(1)(b)
- commencement of business	- ITAA 1997 960-335
- primary production	- ITAA 1997 960-340
- primary production expenses	- ITAA 1997 960-345
- management fee expenses	- ITAA 1997 960-350
- producing assessable income	- ITAA 1936 82KL
- Product rulings	- ITAA 1936 82KZL(1)
- public rulings	- ITAA 1936 82KZM
- schemes and shams	- ITAA 1936 82KZM(1)
- taxation administration	- ITAA 1936 82KZMA
- tax avoidance	- ITAA 1936 82KZMA(4)
- tax benefits under tax avoidance	- ITAA 1936 82KZMB
schemes	- ITAA 1936 82KZMC
- tax shelters	- ITAA 1936 82KZMD
	- ITAA 1936 82KZMD(2)
<i>Legislative references:</i>	- ITAA 1936 82KZME
- ITAA 1997 6-5	- ITAA 1936 82KZME(4)
- ITAA 1997 8-1	- ITAA 1936 82KZME(7)
- ITAA 1997 8-1(1)(a)	- ITAA 1936 82KZMF
- ITAA 1997 17-5	- ITAA 1936 Pt IVA
- ITAA 1997 Division 27	- ITAA 1936 177A
- ITAA 1997 Division 35	- ITAA 1936 177C
- ITAA 1997 35-10	- ITAA 1936 177D
- ITAA 1997 35-10(2)	- ITAA 1936 177D(b)

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