PR 2000/118 - Income tax: Karri Oak Vineyard Project No.3

Product Ruling
Income tax: Karri Oak Vineyard Project No.3

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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 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 Karri Oak Vineyard Project No.3, or just simply as 'the Project'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:

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

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 Grower) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered, or required to be registered for GST and hold a valid tax invoice.

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 'Growers'.

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.

10. A Product Ruling may only be reproduced in its entirety. Extracts may not be reproduced. As each Product Ruling is copyright, apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning

Date of effect

11. This Ruling applies prospectively from 13 December 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 14 August 2000;
- The Karri Oak Vineyard Project No.3 Draft Prospectus, dated 6 November 2000;
- Constitution for the Karri Oak Vineyard Project No.3, undated;
- **Lease and Management Agreement for the Karri Oak Vineyard Project No.3 between Frankland**

Valley Company Ltd [the 'Responsible Entity'], Karri Oak Holdings Ltd ['the Lessor'] and the Grower, undated;

- Compliance Plan for the Karri Oak Vineyard Project No.3, undated;
- Additional correspondence dated 28 September 2000, 14 November 2000 and 15 November 2000.

Note: certain information received from The Frankland Valley Company 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 Growers enter into. 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 a party to, with the exception of finance agreements, to which paragraphs 45 and 46 apply. The effect of these agreements is summarised as follows.

Overview

16. This arrangement involves the Karri Oak Vineyard Project No.3.

Location	South West Region of Western Australia near Mt Barker
Type of business each participant is carrying on	Long term commercial viticulture business
Number of hectares under cultivation	18
Name used to describe the product	Karri Oak Vineyard Project No.3
Size of each Leased Area	0.2 hectares
Number of vines per hectare	1540
Expected production	11.5 tons / hectare
The term of the investment in years	20
Initial cost	$12,375
Initial cost per hectare	$61,875
Ongoing costs	Management and Lease Fees

17. Growers applying under the Prospectus enter into a Lease and Management Agreement. The Lease and Management Agreement gives a Grower a lease from Karri Oak Holdings Ltd, over an

identifiable area of land called a 'Leased Area', until the Project is terminated on the date on which the last of the Growers has been advised that the fruit produce from each area which is leased by the Grower has been harvested and that the relevant Lease and Management Agreement has been terminated but in any event, not later than 31 December 2020. Each Leased Area is 0.2 hectares in size.

18. The Project Land is situated in the South West Region of Western Australia. Karri Oak Holdings Ltd is the owner of the property.

19. Karri Oak Holdings Ltd will lease the Leased Area to the Grower to enable the Grower to carry on a commercial business of growing grapes on the Leased Area for the sale of grapes and grape produce. Growers are specifically granted rights to collect and market the collectable produce from time to time on their Leased Area for this purpose.

20. There is no minimum subscription for this Project. Each investor may subscribe for a minimum of one Leased Area, at a cost of $12,375 per Leased Area. A minimum of 308 vines per Leased Area (1540 vines per hectare) will be planted by the Lessor, Karri Oak Holdings Ltd.

21. Possible projected returns for Growers are outlined in the Draft Prospectus. The risks involved in participating in the Project include the long term nature of establishing, growing and harvesting a commercial vineyard, which is subject to certain risks including physical risks such as fire, insect infestation, disease, frost, hail, storm damage and drought as well as financial risks and general commercial market risks. Growers will execute a Power of Attorney enabling the Responsible Entity, Frankland Valley Co. Ltd, to act on their behalf as required, when they make an application for a Leased Area.

22. Applications under this Project will not be accepted from Growers after 28 February 2001.

Constitution

23. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Grower and to manage the Project. The Responsible Entity will keep a register of Growers (cl 19.1.1). Growers are entitled to assign their Grower's Interest in certain circumstances (cl 16.1.1). The Lease and Management Agreement is annexed to the Constitution and will be executed on behalf of a Grower following them signing the Application and a Power of Attorney Form in the Prospectus. Growers are bound by the Constitution 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. Under the Compliance Plan, a Compliance Committee will monitor to what extent the Responsible Entity meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

Interest in Land

25. A lease is granted by the Land Owner, Karri Oak Holdings Ltd, to the Grower under the terms of the Lease and Management Agreement (Cl 2). Growers are granted an interest in land in the form of a lease to use their Leased Areas for carrying on the business of a long term commercial viticulture project (cl 56.2). Growers must pay rent annually to the Lessor. The term of a Grower's lease is up to 31 December 2020.

Management Agreement

26. Each Grower enters into a Lease and Management Agreement with the Responsible Entity for each Leased Area. The termination of the project will be on the date on which the last of the Growers has been advised that the fruit produce from each area which is leased by the Grower has been harvested and that the relevant Lease and Management Agreement has been terminated but in any event, not later than 31 December 2020.

27. Growers contract with the Responsible Entity to train, maintain, supervise and manage, in accordance with good commercial practice all the vines, the vineyard and the commercial viticultural activities to be carried on by the Grower on the Leased Area. Growers pay a Management Fee for each Leased Area on subscription and an annual management fee thereafter.

28. The Responsible Entity will carry out the following services under this agreement:-

- ensure the Lessor has planted sufficient rootlings or cuttings on the leased area;
- cultivate, tend, train, prune, fertilise, replant, spray and otherwise care for the vines as and when required;
- maintain the irrigation system to the vines on the leased area;
- maintain and repair the trellising systems to support the vines;

- use all reasonable measures to keep the leased area free from vermin, noxious weeds, pests and diseases;
- maintain the leased area according to good viticultural practices;
- replace any vines that fail to establish or that die during the first 12 months of the project; and
- harvest the fruit grown on the leased area each year and deliver it up for sale.

29. Growers may elect to collect and market their own harvested collectable produce (cl.69.1). However, where Growers do not elect, the Responsible Entity will harvest and market the fruit produce from the leased area to obtain the highest practicable price for the fruit produce from the vineyard and to ensure that in all other respects any agreement for sale or marketing entered into is in the best interests of the Grower (cl.70.2).

30. Growers will only be offering up for sale the fruit grown on their leased area and will not be involved in purchasing in fruit from other sources.

31. The Responsible Entity will be responsible for paying for the cost of annual insurance against public risk in respect of the vineyard (cl.72.1).

32. The Responsible Entity will, if requested by the Grower, use its best endeavours to arrange insurance of the Leased Area (including the vines on or fruit produce from the Leased Area) on behalf of the Grower against destruction or damage by fire. This insurance, to be paid for by the Grower, will compensate for any loss of produce from the vines which would be assessable income to the Grower (cl.72.1.2).

Fees

33. The initial fee payable under the Lease and Management Agreement is the Subscription Sum of $12,375 per Leased Area payable on application for the care and cultivation of the vines (cl. 89) This service will be carried out by 30 June 2001.

34. A Management Fee of $3,355 is payable on or before 31 July 2001 for services to be carried out in the period 1 July 2001 to 30 June 2002.

35. A Management Fee of $2,420 is payable on or before 31 July 2002 for services to be carried out in the period 1 July 2002 to 30 June 2003.

36. A Management Fee of $1,760 is payable on or before 31 July 2003 for services to be carried out in the period 1 July 2003 to 30 June 2004.

37. For the periods commencing 1 July 2004 and onwards, an annual Management Fee, equal to the previous years management fee PLUS the greater of 3% of the previous years management fee or the percentage increase in the Consumer Price Index (All Groups, Perth) between the quarter ending 30 June 2001 and the quarter ending 30 June prior to the date of payment, is payable each year for the period 1 July to 30 June and is payable on or before 31 July of the year in which the services are provided.

38. A Lease Fee of $660 is payable on application for rent for the period up to 30 June 2001. An annual Lease Fee of $660 is payable on or before 31 July of each year, for rent on the Leased Area for the periods 1 July 2001 to 30 June 2002 and 1 July 2002 to 30 June 2003.

39. For the period commencing 1 July 2003 and onwards, an annual rental fee is payable on or before 31 July of the year in which the services are provided and is to be calculated in accordance with the formula:-

A = $660 x B/C

Where A = the rent payable; B = the Consumer Price Index (All Groups, Perth) for the March quarter prior to calculations; and C = the Consumer Price Index (All Groups, Perth) for the March quarter in 2003.

This annual fee is first payable on or before 31 July 2003.

40. The Independent Expert has prepared a report stating that the site appears to be well suited to the production of premium quality wine grapes. The latest industry management techniques will be utilised on this Project.

41. The Application Monies will be held in a trust account on trust for the Grower (cl 9.05).

Planting

42. During the period up to 30 June 2001 the Lessor will be responsible for planting the vines on the leased area and the Responsible Entity will maintain the vines in accordance with good commercial practice. The services to be provided by the Responsible Entity over the term of the Project are outlined in the Lease and Management Agreement (cl. 95).

43. The Harvest shall take place commencing from the date of the first commercially harvestable fruit crop from the vineyard, at such time or times as in the opinion of the Responsible Entity will

maximise the price receivable for such fruit produce. For non-electing Growers, the Responsible Entity will be responsible for arranging the marketing and sale of the fruit produce.

44. The proceeds from the sale of the fruit produce from the vineyard will be paid into a separate produce fund. Proceeds received by the Responsible Entity are to be distributed in the following order of priority:

- to the Responsible Entity for any amounts it is entitled to under clause 33.4 of the Constitution;
- any annual contributions from prior years for any of the non-electing growers that may be due but unpaid;
- any annual contributions due and payable by non-electing growers under clause 23 for the succeeding financial year;
- any amounts payable by the non-electing growers under the Lease and Management Agreement or the Constitution; and
- the balance of the produce fund to each of the non-electing growers in proportion to their interest in the fund.

Finance

45. All Growers are required to fund their investment in the Project themselves or borrow from an independent lender.

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

1. there are split loan features of a type referred to in Taxation Ruling TR 98/22;
2. there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
3. 'additional benefits' are or will be granted to the borrowers, for the purposes of section 82KL, or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
4. terms or conditions are non-arm's length;
5. repayments of the principal and payments of interest are linked to the derivation of income from the Projects;

6. 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;
7. lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
8. entities associated with the Project are involved or become involved, in the provision of finance to Growers for the Project.

Ruling

Assessable Income

47. A Grower's share of the gross sales proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

Section 8-1

Deductions where a Grower is <u>not</u> registered nor required to be registered for GST

48. A Grower may claim tax deductions in the Table below where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 33 to 39; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Year 1 deductions	Year 2 deductions	Year 3 deductions
Management Fee	8-1	$11,715 – See Note (i) (below)	$3,355 – See Note (i) (below)	$2,420 – See Note (i) (below)
Lease Fee (Rent)	8-1	$660 – See Note (i) (below)	$660 – See Note (i) (below)	$660 – See Note (i) (below)
Interest		See Note (ii) (below)	See Note (ii) (below)	See Note (ii) (below)

Notes:

(i) Where a Grower 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 Grower **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 prepayments 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 that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, all Growers who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraph 87 to 89 below as those rules may be applicable if interest is prepaid.

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

49. Where a Grower who is registered or is required to be registered for GST:

- participates in the Project by 30 June 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 33 to 39; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Table above will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 94.

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

50. For a Grower 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.

51. 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 (see paragraph 68 in the Explanations part of this Ruling, below).

52. 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.

53. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Growers 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, 82KZMB – 82KZMD, 82KZME – 82KZMF, 82KL and Part IVA

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

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 76 to 83);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 76 to 83);
- expenditure by the Grower 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

55. 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), and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

Is the Grower carrying on a business?

56. A viticulural 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 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.

57. Generally, a Grower will be carrying on a business of viticulture where:

- the Grower has an identifiable interest in specific growing vines coupled with a right to harvest and sell the produce from the vines;

- the viticulture 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.

58. For this Project Growers 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. Under the Lease and Management Agreement Growers appoint Frankland Valley Co. Ltd, as Responsible Entity, to cultivate, tend, train, prune, fertilise, replant, spray and otherwise care for the grape vines as and when required that is consistent with Good Viticultural Practice and to use all reasonable measures to keep the Leased Area free from vermin, noxious weeds, pests and diseases. Growers are considered to control their investment.

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

60. Growers have the right to use the land in question for viticulture purposes and to have the Responsible Entity come onto the land to carry out its obligation under the Lease and Management Agreement. The Growers' 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, Growers are entitled to receive regular progress reports on the Project by Frankland Valley Co Ltd. Growers 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 the Responsible Entity being placed in liquidation or official management. The viticultural activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

61. 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 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.

62. 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. 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.

63. Growers 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 Growers' viticulture activities will constitute the carrying on of a business.

64. The lease and management fees associated with the viticulture 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 fruit produce) 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.

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. Under the loss deferral rule in subsection 35-10(2) the relevant loss is not able to be taken into account in the calculation of taxable income in the year that loss arose. Instead, in a later year it may be offset against any income from the same or similar business activity, or, if one of the objective tests is passed, or the Commissioner's discretion exercised, against other income.

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 Growers 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 Grower 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 Grower 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 2006. Growers 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 Grower'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 Grower 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 Grower'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 50), in the manner described in the Arrangement (see paragraphs 14 to 46), 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 $11,715 and Lease Fee of $660 per Leased Area 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 Grower by 30 June of the year of execution of the Agreements. 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 Responsible Entity doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On

this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraphs 33 to 39, 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.

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

79. Although not required under either the Lease and Management Agreement, a Grower 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 Grower is a 'small business taxpayer'.

81. Where a Grower 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 Grower 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 Grower is a 'small business taxpayer' or section 82KZMD if the Grower 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(4) 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 Grower acquires more than one interest in the Project and the quantum of 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.

Subdivision 960-Q - 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 Grower is a 'small business taxpayer' depends upon the circumstances of each Grower and is beyond the scope of this Product Ruling. It is the responsibility of each Grower to determine whether or not they are within the definition of a 'small business taxpayer'.

Interest deductibility

87. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other 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.

88. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in sections 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. It will encompass

activities not described in the Arrangement or otherwise dealt with in the Product Ruling, such as a loan to finance participation in the Project.

89. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for a period that ends more than 13 months after the expenditure has been incurred, any tax deduction that may be allowable must be determined under section 82KZM (for a 'small business taxpayer') or section 82KZMD (for a taxpayer who is not a 'small business taxpayer'). The relevant formula is the same, or effectively the same as that shown above in paragraph 81 above.

Section 82KL - recouped expenditure

90. 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

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

92. The Karri Oak Vineyard Project No.3 will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraph 48 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.

93. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the grape produce. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing 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'

94. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management 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 however, is reduced by the amount of any 'input tax credit' to which she is entitled. The Project Responsible Entity provides Margaret with a 'tax invoice' showing its ABN and the price of the taxable supply for management services as $5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

1/11 x $5,500 = $500

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

Detailed contents list

95. Below is a detailed contents list for this Product Ruling:

Commissioner of Taxation
13 December 2000

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 97/11; TR 97/16; TD 93/34; IT 175; IT2001; TR 92/20; TR 98/22

Subject references:

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

Legislative references:

- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 17-5
- ITAA 1997 Div 27
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-30
- ITAA 1997 35-35
- ITAA 1997 35-40
- ITAA 1997 35-45
- ITAA 1997 35-55
- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
- ITAA 1997 960-335
- ITAA 1997 960-340
- ITAA 1997 960-345
- ITAA 1997 960-350
- ITAA 1936 82KL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZM(1)
- ITAA 1926 82KZMA(4)
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZMD(2)
- ITAA 1936 82KZME
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZMF
- ITAA 1936 82KZMF(1)
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C
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ATO references:
NO 2000/014154
BO
FOI number: I 1022369
ISSN: 1441-1172