

PR 2000/93 - Income tax: Margaret River Wine Business (Project No.2)

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 This document has changed over time. This is a consolidated version of the ruling which was published on *8 November 2000*



Product Ruling

Income tax: Margaret River Wine Business (Project No.2)

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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.*

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

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 Margaret River Wine Business Project No.2, or just simply as 'the Project'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- section 6-5 of the *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 of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KZM and 82KZMB - KZMD (ITAA 1936);
 - section 82KZMF (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. All fees and expenditure referred to in this Ruling 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. The Commissioner rules on the precise arrangement identified in this Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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- the Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 23 August 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'], Margaret River Wine Production Ltd [the Wine Production Company] and the Member, undated;**
- Wine Processing Agreement between Margaret River Wine Production Ltd and Palandri Wines Ltd;
- Vineyard Management and Maintenance Agreement between Palandri Wines Ltd and Quenby Viticultural Services Pty Ltd, undated; and
- Vineyard Establishment Agreement between Margaret River Wine Production Ltd and Quenby Viticultural Services Pty Ltd, undated;
- Additional correspondence dated 26 May 2000 and 22 June 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, which are part of the arrangement. The effect of these agreements is summarised as follows.

Overview

16. These arrangements are called the Margaret River Wine Business Project No.2.

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	To carry 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	Margaret River Wine Business Project No.2
Size of each Vineyard Lot	0.023 hectares
Number of vines per hectare	1852

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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 Management and Lease Agreement. Margaret River Wine 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. Margaret River Wine Production Ltd holds a Head Lease over the land.

19. Margaret River Wine 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 Margaret River Wine 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 Management and Lease 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 Management and Lease 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, Margaret River Wine Production Ltd, to the Members under the terms of the Management and Lease 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. The term of a Member's lease is from the Commencement Date until 30 June 2018. This amount includes GST.

Management and Lease Agreement

26. Each Member enters into a Management and Lease 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 Members 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 this 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 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 delivery of 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 Management and Lease 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 L&MA.).

Fees

34. The total Fee payable in the first year under the Management and Lease 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 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, are involved or become involved, in the provision of finance to Members for the Project.

43. There is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Members for any purpose associated with the Project.

Ruling

Section 8-1

Deductions where Members are not registered or not required to be registered for GST.

44. For a Member who invests in the Project during the year ended 30 June 2001 to carry on a business of growing grapes and producing wine, the following deductions will be available for the years ended 30 June 2001 to 30 June 2003, provided the Member is not registered, or not required to be registered, for GST during this period:

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 notes (i) and (ii) below	\$4,010 See notes (i) and (ii) below
Lease Fee	8-1	\$165	\$165 See note (ii) below	\$170 See note (ii) below
Interest	8-1	See note (iii) below.	See note (iii) below.	See note (iii) below.

Notes:

- (i) Any prepaid Management fees shown in the table above are **NOT** deductible in the year incurred. The income tax deduction for each year's fees **MUST** be determined using the formula shown in paragraph 49.

- (ii) Management or lease fees of less than \$1,000 will be 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred. Deductibility of lease fees that exceed \$1,000, such as may occur where a Member acquires a number of interests in the Project, will be determined on the same basis as any prepaid Management fees, i.e., using the formula shown in paragraph 49).
- (iii) The deductibility or otherwise of interest arising from agreements that Members enter into to finance their participation in the Project is outside the scope of this Ruling. However, Members should read carefully the discussion of the prepayment rules in paragraphs 72 to 76 below as those rules may be applicable if interest is prepaid.

Deductions where Members are registered or required to be registered for GST

45. Where a Member who is registered, or required to be registered, for GST invests in the Project, and is entitled to an input tax credit, the amount of the deduction is reduced by the amount of the 'input tax credit' (Division 27 of ITAA 1997) See Example at paragraph 97.

Sections 82KZM and 82KZMB – 82KZMD

46. 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 applications as indicated:

- i. the expenditure by Members does not fall within the scope of section 82KZM;
- ii. the expenditure by Members does not fall within the scope of sections 82KZMB-82KZMD;

Section 82KL

47. Section 82 KL does not apply to deny the deductions otherwise allowable; and

Part IVA

48. 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.

Prepaid Fees

49. In this Project the Lease and Management Agreement that Members enter into does not require fees to be paid by Members prior to the commencement of each eligible service period. If however, a Member chooses to incur expenditure in respect of services to be provided for a period that has not yet commenced then the prepayment will not be deductible in full in the year in which it is incurred. Rather, using the formula shown below, the prepayment provisions of the ITAA 1936 will operate to allow the income tax deduction in the period that the prepaid benefits are provided (see paragraphs 72 to 76).

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

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

50. 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 2004 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 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 86 in the Explanations part of this ruling, below).

52. Where either the Member'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 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.

Section 6-5 - Assessable Income

53. 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 ITAA 1997.¹

Explanations**Section 8-1 ITAA 1997**

54. It is appropriate, as a starting point, to consider whether lease and management fees are deductible under paragraph 8-1(1)(a). This consideration proceeds on the following basis:

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

55. A vineyard and wine business project can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from grapes 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 tending, maintaining and harvesting of the vines and the production, marketing and sale of wine.

56. Generally, a Member will be carrying on a vineyard business where:

¹ Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from taxable income.

- the Member has an identifiable interest in specific grape vines coupled with a right to harvest and sell the grapes produced;
- the vineyard 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.

57. Under the Lease, Members have rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of a commercial vineyard. Under the Lease and Management Agreement, Members appoint Palandri Wines Ltd, as Responsible Entity, to carry out viticulture farming in accordance with the agreement. The agreement gives Members full right, title and interest in the Vines and Grape Produce and the right to have the wine sold for their benefit.

58. Under the Lease and Management Agreement, Members appoint the Responsible Entity to provide services such as maintain a trickle irrigation system, cultivate, tend and care for the Vines according to good viticultural practices. The Responsible Entity is also responsible for harvesting the grapes and producing and marketing wine from the grapes. The specific cost of these services provided in the initial period is \$10,835.

59. The Lease gives Members an identifiable interest in specific vines and a legal interest in the land by virtue of a lease. Members elect to use the Responsible Entity, Palandri Wines Ltd, to market the produce for them.

60. Members have the right to use the land in question for the cultivation of vines and harvesting of grapes and to have the Responsible Entity enter the land to carry out its obligations under the Lease and Management Agreement. The Members' degree of control over the Responsible Entity, as evidenced by the Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, Members are entitled to receive regular progress reports on the Responsible Entity's activities. Members are able to terminate arrangements with the Responsible Entity in certain instances, such as cases of a breach of a substantial nature by the Responsible Entity of its obligations or the Responsible Entity going into liquidation. The activities described in the Lease and Management Agreement are carried out on the Members' behalf.

61. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Members to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the Prospectus that suggest

the Project should return a 'before-tax' profit to the 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.

62. Members will engage the professional services of a Manager with appropriate credentials. The services are based on accepted viticulture practices and are of the type ordinarily found in viticulture practices activities.

63. Members have a continuing interest in the vines from the time they are acquired until they reach the end of the most productive period of their life. There is a means to identify which vines Members have an interest in. The vineyard 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' vineyard activities will constitute the carrying on of a business.

64. The management fees and lease fees associated with the vineyard 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 grape 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. No capital component is identifiable. The tests of deductibility under paragraph 8-1(1)(a) are met. The exclusions of subsection 8-1(2) do not apply.

Sections 82KZM and 82KZMB - 82KZMD ITAA 1936

65. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full under section 8-1 of the ITAA 1997. The section applies to certain expenditure incurred under an agreement in return for doing of a thing under the agreement that is not wholly done within the same year of income as the execution of the relevant agreement.

66. Under the Lease and Management Agreement, fees of \$11,000 per Vineyard Lot will be incurred during the year in which the Agreement is executed. The fees are charged for providing services to a Member by 30 June of the year of execution of the Agreement. The fees are expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the arrangement's description that the fees have been inflated to result in reduced fees being payable for subsequent years.

67. There is also no evidence that might suggest the services covered by the fees could not be provided in 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 fees are for the Project Manager doing ‘things’ that are not to be wholly done within the year of income of the fees being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure incurred by the Member.

68. New sections 82KZMB, 82KZMC and 82KZMD will also have no application to this Project, provided the Member incurs the fees as they fall due under the Lease and Management Agreement, since the services to be provided in respect of the initial fees are completed in the same year of income as the expenditure is incurred.

Section 82KL ITAA 1936

69. The operation of section 82KL depends, among other things, on the identification of a certain quantum of ‘additional benefits’. In the project, insufficient ‘additional benefits’ will be provided to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA ITAA 1936

70. 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). The Project will be a ‘scheme’, commencing when the Prospectus is issued. The Members will obtain an initial ‘tax benefit’ from entering into the scheme, in the form of the deduction for the initial fee, allowable under section 8-1, that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

71. Members to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of wine produce. The Independent Viticulturalist’s Report contained in the Prospectus states that with appropriate establishment procedures and sound management, this Project can achieve its aims and objectives as outlined in the Prospectus. There are no features of the Project that might suggest the Project was so ‘tax driven’, and so designed to produce a tax deduction of a certain magnitude that would attract the operation of Part IVA.

Prepaid Fees

72. The amount and timing of deductions for any prepaid Management Fees, Lease Fees or interest otherwise deductible under

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section 8-1 will depend on 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.

73. Where a Member participating in this Project incurs expenditure in respect of the doing of things (e.g., the performance of management services or the lending of money), prior to the commencement of the eligible service period, the prepaid expenditure is not deductible in the year in which it is incurred. Rather, the prepayment provisions of the ITAA 1936 will operate to allow the income tax deduction in the period that the prepaid benefits are provided. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and whether the Member is a 'small business taxpayer'.

74. 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.

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

75. 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 small business taxpayers the amount and timing of the allowable deductions will then be calculated under the formula in subsection 82KZM(1) and for non-small business taxpayers under the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 74 above, concerning section 82KZMF.

76. Prepaid management and lease fees of less than \$1,000 in each 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 Member acquires more than one interest in the Project and the quantum of prepaid management fees or prepaid lease fees is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown above.

Interest Deductibility

77. 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.

78. 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 section 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and will encompass activities, such as a loan to finance participation in the Project that is not described in the Arrangement or otherwise dealt with in the Product Ruling.

79. 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 determine any tax deduction using the formula in subsection 82KZMF(1), as shown above at paragraph 76.

Small business taxpayers

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

81. 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.

82. '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).

Division 35, Losses from non-commercial business activities

83. 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;

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- 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.

84. 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.

85. 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.

86. 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.

87. 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).

88. 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.

89. 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.

90. 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.

91. 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.

92. 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 50), in the manner described in the Arrangement (see paragraphs 14 to 43), 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.

93. 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 and additional expert or scientific evidence provided with the application by the Responsible Entity.

Section 6-5 ITAA 1997: assessable income

94. 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 Members, under section 6-5 of ITAA 1997. Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

95. Once harvested, a Member's grapes will be trading stock of the Member, as will any bottled wine from those grapes. As a

consequence, if grapes or grape juice or bottled wine are on hand at the end of the income year, the Member will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of ITAA 1997.

96. Each Member will be notified by Palandri Wines Ltd of the respective amounts to be brought to account in proportion to their total holding in the Project, in accordance with part 2-25 and Taxation Ruling IT 2001.

Examples

Example 1 – Entitlement to ‘input tax credit’

97. 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 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 in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 less \$500).

Detailed contents list

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Commissioner of Taxation

23 August 2000

<i>Previous draft:</i>	- ITAA 1997 8-1
Not previously issued in draft form	- ITAA 1997 17-5
	- ITAA 1936 82KL
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZM
PR 1999/95; TR 92/1; TR 97/11;	- ITAA 1936 82KZMB
TR 97/16; TD 93/34; IT 175;	- ITAA 1936 82KZMC
IT 2001; TR 92/20; TR 98/22	- ITAA 1936 82KZMD
	- ITAA 1936 82KZMF
<i>Subject references:</i>	- ITAA 1936 Pt IVA
- carrying on a business	- ITAA 1936 177A
- commencement of business	- ITAA 1936 177C
- fee expenses	- ITAA 1936 177D
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- primary production	- ITAA 1997 35-10
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	- TAA 1953 Pt IVAAA
<i>Legislative references:</i>	- Copyright Act 1968
- ITAA 1997 6-5	

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