

STD 98/D3 - Contract winemaking



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Draft Sales Tax Determination

Title: **Contract winemaking**

Background

In the wine industry it is common practice for grape growers to supply grapes to contract winemakers (CWMs) to be made into wine. The CWM undertakes specific activities on behalf of the grape growers. These activities may include crushing, fermentation, maturation, filtration, blending and, in some cases, bottling.

If most, or all of the grapes used in the winemaking process are supplied by the grape grower, the CWM will not legally be the owner of the wine produced. Consequently, the delivery of the wine manufactured by the CWM to the grape grower will not be a sale of goods. Under the sales tax law, delivery of wine in this situation is treated as a separate assessable dealing (referred to as a taxing point for the purpose of this draft Determination) known as a *delivery of customer's materials goods*. Sales tax is payable on this dealing unless an exemption applies.

It has come to the attention of the Australian Taxation Office (ATO) through audits in Western Australia and discussions with the Winemakers' Federation of Australia (WFA) that some grape growers and CWMs are not aware of this assessable dealing.

In some cases, the grape growers who supply the grapes to a CWM consider themselves to be the winemaker when, in fact, the CWM is the manufacturer for sales tax purposes.

This draft Determination sets out the ATO view on the operation of the sales tax legislation in relation to contract winemaking and explains the responsibilities for both CWMs and for grape growers who supply CWMs with grapes to be made into wine.

Issue

1. When does a taxing point apply to a CWM?
 2. When does a taxing point apply to a grape grower who supplies grapes to a CWM?
-

Decisions**1. Contract winemakers:**

Flowchart A illustrates the taxing points that can apply to CWMs. Taxing Points 1 to 4 are assessable dealings known as *delivery of customer's materials goods*. Unless the grape grower quotes a sales tax registration number to the CWM, tax is payable at these taxing points.

The value on which sales tax is payable (known as the taxable value) is the amount (excluding sales tax) charged to the grape grower in respect of the wine or grape juice, plus the notional wholesale purchase price for the grapes.

2. Grape growers:

Flowchart B illustrates the sales tax liability of grape growers who receive bottled or packaged wine from the CWM. The wine is for sale or application to own use (AOU).

Flowchart C illustrates the sales tax liability of grape growers who receive bulk wine from the CWM. The wine is subsequently bottled or packaged by the grape grower for sale or AOU.

Flowchart D illustrates the sales tax liability of grape growers who receive raw wine from the CWM. The grape grower manufactures commercially saleable wine from the raw wine for sale or AOU.

In these flowcharts the grape grower may incur sales tax liabilities at Taxing Points 5 and 6. The taxing points can involve the following assessable dealings:

- Wholesale sales - sales to a person who purchases for the purpose of resale, for example, sales to retail liquor shops and restaurants.
- Retail sales (only if the wine has not been taxed) - sales to a person who consumes the goods, for example, cellar door sales.

- AOU (only if the wine has not been taxed) - goods that will be used by the winery, for example, wine for tastings and wine shows.

Small business exemption

If you pay \$10,000 or less per year in sales tax, you may be eligible for the small business exemption. If so, you can choose to pay sales tax on all your raw materials, business inputs and trading stock and sell your wine free of sales tax. The 'small business' person may be either a manufacturer or a wholesaler or both. The exemption is based on tax payable and not on annual sales.

The flowcharts in this draft Determination do not apply to persons who have elected to adopt the small business exemption.

Sales Tax Bulletin No 18 contains information on the small business exemption and is available from the ATO. For more information, telephone **13 28 66**.

Date of effect

This draft Determination confirms the existing policy of the ATO and, when released as a final Determination, will be effective immediately.

Reasons

The scheme of the sales tax legislation is to tax goods manufactured in or imported into Australia but does not tax Australian-used goods.

We have based our decision on the following legislative provisions:

In the sales tax legislation in force before 1993, there were a number of situations where a person was deemed to be the manufacturer of goods. Under the current legislation (effective from 1 January 1993) these deeming provisions have been removed and the law treats the transactions according to their true identity.

Sections 5, 16, 18, 22 and 29 of the Sales Tax Assessment Act 1992; AD1a, AD1b, AD2a, AD2b, AD3b, AD3c and AD4a of Table 1 to the Sales Tax Assessment Act 1992

Delivery of grapes to a contract winemaker

Where goods are manufactured by a person (e.g., a CWM) from materials supplied by a customer (e.g., a grape grower), the delivery of the completed goods back to the customer is treated as an assessable dealing. This assessable dealing is known as a *delivery of customer's materials goods*.

When a *delivery of customer's materials goods* occurs, the value on which sales tax is payable (known as the taxable value) is the amount (excluding sales tax) charged to the customer in respect of the goods, plus the notional wholesale purchase price for any always-exempt goods included in the materials supplied by the customer. Grapes are always-exempt goods. A value for the grapes therefore needs to be determined to enable the CWM to calculate correctly the taxable value.

Some CWMs may experience difficulty in determining the value of the grapes. In order to give certainty to the CWM, the WFA and the ATO have agreed on a basis for determining this value. In consultation with the WFA, a five year weighted average price of the various types of grapes, based on the grape growing regions of South Australia, will be determined annually. This value will be made available to CWMs on contacting their local ATO or the WFA. The CWM has the option of using this value or determining some other value. If using another value, the CWM must be able to support that other value.

The purpose for including the grapes in the taxable value applicable to a *delivery of customer's materials goods* is to place the grape grower in the same position as other manufacturers of wine. Other manufacturers, by necessity, sell their wine at a price that reflects all costs and a profit margin. This includes the cost of grapes used in manufacturing the wine. There is a specific intention in the sales tax legislation to ensure that both dealings are treated equitably by including the value of grapes in the taxable value of a *delivery of customer's materials goods*.

In nearly all circumstances, it is expected that the CWM will be the manufacturer of the wine. However, in certain situations the grape grower may be considered to be the manufacturer for sales tax purposes.

For example, even though wine has been manufactured at a CWM's premises using the CWM's equipment, the grape grower may be considered to be the manufacturer under the following conditions:

- the grape grower must have the ultimate control of, and responsibility for, the wine making process;
- the grape grower must actively participate in the process; and

- the grape grower must have the knowledge, experience and skill as a winemaker to produce the wine.

Where the CWM has the ultimate control over, and responsibility for, the winemaking process, the CWM will be the manufacturer of the wine for sales tax purposes. This is so, even if the grape grower participates in the wine production activities.

Whether or not a grape grower holds a producer's licence in accordance with a particular State's liquor licensing legislation is not a factor used in deciding whether that grape grower is a manufacturer of wine for the purpose of the sales tax legislation. The expressions '*manufacture*' and '*manufacturer*' are defined in general terms in the legislation. These definitions are used for determining whether a grape grower is a wine manufacturer for sales tax purposes. State liquor licensing legislation uses a specific definition of a wine producer, which is not related to the sales tax legislation. Each State liquor licensing authority determines the entitlement of a grape grower to a producer's licence independently from the sales tax legislation.

Barrels supplied to a contract winemaker

Barrels supplied to a CWM can be purchased free of sales tax by grape grower in either of the following situations:

- where the grape grower is the manufacturer of the wine for sales tax purposes even though the manufacturing process is being carried out at the CWM's premises; or
- where the grape grower is selling the wine manufactured by the CWM mainly (that is, more than 50%) by wholesale and the barrels are for use mainly in storing the wine at the grape grower's premises.

Barrels supplied to a CWM **cannot** be purchased free of sales tax by a grape grower in the following situations:

- where the grape grower is selling the wine, manufactured by the CWM, mainly by retail; or
- where, as part of the maturation process, raw wine is placed in barrels supplied by the grape grower and the grape grower is not involved in any manufacturing process (see Flowcharts B and C). Where the grape grower does undertake a manufacturing process, as in Flowchart D, the grape grower is entitled to purchase the barrels free of sales tax.

The purpose of excluding the grape grower who is not involved in manufacturing wine from purchasing barrels free of sales tax is to place the grape grower in the same position as other manufacturers of wine. If the grape grower purchases barrels for use by the CWM, the cost of the barrels is excluded from the CWM's costs and excluded from the taxable value applicable to a *delivery of customer's materials goods* dealing. Other manufacturers sell their wine at a price that reflects all costs, including the cost of the barrels, and a profit margin. Sales tax is therefore charged on these costs plus the profit. For these dealings to be treated equally, sales tax must be included in the price charged to the grape grower when purchasing these barrels or at the time of AOU.

Under the pre-1993 sales tax law, if a grape grower supplied grapes to a CWM and intended to re-sell the produced wine by retail, the grape grower was deemed to be the manufacturer of the wine and was liable for the sales tax. The policy intention of the deeming provisions was to postpone the taxing point if some of the costs of production were incurred by a person who was not the physical manufacturer of the goods, so that those costs were brought within the sales tax base. As the deemed manufacturer, it was quite common for the grape grower to purchase barrels free of sales tax and supply them to the CWM. When the wine was sold by the grape grower, the price would reflect all costs, including the cost of barrels, and a profit margin. Sales tax would have been charged on these costs plus the profit. The cost of the barrels was therefore included in the sales tax base at the time of the sale of the wine. This was in accordance with the intended operation of the deeming provisions under the old law.

Under the current law, the physical manufacturer of the wine, the CWM, is treated as the manufacturer and is liable to pay sales tax on the *delivery of the customer's materials goods* to the grape grower. Sales tax is accounted for on the amount charge by the CWM for manufacturing the wine, plus the value of the grapes supplied by the grape grower. The cost of grapes (grapes being always-exempt goods) supplied by the grape grower is included in the value on which sales tax is charged. The legislation is structured to ensure that the other costs incurred by the grape grower in producing the wine, such as the supply of barrels, are included in the sales tax base. Sales tax is payable on these goods at the time of their purchase or AOU.

Sales tax on the barrels is therefore accounted for under both the old and current law. The old law accounted for sales tax on the barrels at the time of sale of the wine, whereas the current law accounts for sales tax on the barrels at the time of their purchase or AOU.

Manufacture of wine

To determine when a *delivery of customer's materials goods* occurs during the overall process of converting grapes to commercially saleable wine, it is necessary to look at the separate activities and determine whether they constitute manufacture. It is also important to identify at what stage the goods are returned to the customer.

'*Manufacture*' and '*Manufacturer*' are defined in section 5 of the *Sales Tax Assessment Act 1992*.

'*"Manufacture" includes:*

- (a) *production;*
- (b) *combining parts or ingredients so as to form an article or substance that is commercially distinct from the parts or ingredients; ...*

but does not include:

- (g) *any action or process by which goods come into existence incidentally to the performance of work whose essential character is the performance of skilled services and not the bringing into existence of goods for the essential object of selling the goods or applying them to own use; ...'*

'*"Manufacturer" in relation to particular goods, means the person who (not as an employee) manufactured the goods, whether or not the person owned the materials out of which the goods were manufactured.'*

The overall process of converting grapes to commercially saleable wine sold in bottled or packaged form (e.g., cask) is manufacture. A number of separate activities are involved in this process. Where these activities are performed by the same person, each of the activities forms part of the manufacturing process.

However, it may be that one activity is performed in isolation. Does that activity constitute manufacture by itself?

These activities or processes, which are similar for producing various types of wines from grapes, include:

- grape crushing;
- fermentation;
- maturation, filtration and blending; and
- bottling.

Each of the following activities is considered to be manufacture, whether performed by the grape grower or by the CWM from grapes supplied by the grape grower:

Crushing (for red and white wine grapes) and pressing (for white wine grapes)

A process is applied to the grapes that results in a product known as 'must'. 'Must' is newly pressed juice of grapes or other fruit ready for fermentation. It is a commercially distinct product from the grapes. Manufacture has occurred in terms of paragraph (a) and/or paragraph (b) of the definition of '*manufacture*'.

Fermentation

Fermentation is a process which involves converting the 'must' into raw wine. This process involves:

- pumping the 'must' into a fermentation vessel;
- introducing fermenting yeast to the 'must' to induce alcoholic fermentation;
- extracting the colour, flavour and tannin as fermentation progresses for whatever type of wine is being produced; and
- controlling the temperature for fermentation which in turn controls the rate of fermentation.

Fermentation is complete and raw wine has been produced when the fermentable sugars are converted to alcohol and carbon dioxide.

The process of converting the 'must' to raw wine is manufacture in terms of paragraph (a) and/or paragraph (b) of the definition of '*manufacture*'.

Maturation, filtration and blending

The raw wine goes through a series of processes, including:

- racking, to clarify the wine by removing unwanted solids;
- adding lactic acid bacteria to induce malolactic fermentation;
- adjusting sulphur and acid contents;
- cold stabilisation and filtration; and
- blending with other wine that the wine manufacturer has either manufactured or purchased.

These processes, in addition to the naturally occurring maturation process, convert the raw wine into a commercially saleable wine. While the difference in physical appearance of the goods may be slight, a new and commercially distinct article is brought into existence. In view of the degree of change, new goods have been manufactured.

The blending of wine, when undertaken by a wine manufacturer in conjunction with the production of wine, is accepted as being part of the overall manufacturing process.

Each type of wine may go through all or some of the processes referred to above. Nevertheless, the principles involved for converting raw wine to commercially saleable wine are similar and manufacture is involved in terms of paragraph (a) and/or paragraph (b) of the definition of '*manufacture*'.

The following activities are **not** considered to be manufacture when undertaken in isolation:

Bottling

As a separate activity, the bottling of wine is not '*manufacture*'. No new product has been produced. Wine has merely been placed in bottles or casks for eventual sale or AOU.

However, where the bottling is undertaken by the wine manufacturer or a subcontractor to the wine manufacturer for wine that the manufacturer has produced, then this activity becomes part of the overall process of manufacturing wine.

Blending

The blending of Australian or imported wine does not by itself constitute '*manufacture*'. For example, a person who merely purchases wines for blending will not incur a further sales tax liability when selling the wines by retail. Any sales tax liability will be satisfied by payment of sales tax at the time of purchase.

Persons who purchase wines for blending and resale by wholesale will incur a liability for sales tax on those wholesale sales. Therefore, they are entitled to quote their registration number at the time of purchase, if registered, and are liable to account for tax on the sale or AOU of the blended wine.

As stated earlier, the blending of wine, when undertaken by a wine manufacturer in conjunction with the production of wine, is accepted as being part of the overall manufacturing process.

Taxing points (TPs)

A sales tax liability is imposed on assessable dealings (referred to in this draft Determination as taxing points) with assessable goods. Assessable dealings are transactions that give rise to a sales tax liability unless an exemption applies. Assessable goods include goods that have been manufactured in Australia.

Flowcharts A, B, C and D indicate when TPs occur.

TP 1 - Delivery of customer's materials goods

When grapes are crushed, new goods are produced.

- If the CWM is engaged in crushing/pressing grapes for the grape grower, then on delivery of the crushed grapes ('must') to the grape grower an assessable dealing has occurred. This assessable dealing is a *delivery of customer's materials goods*. Sales tax is payable on this dealing if the grape grower does not quote a sales tax registration number.
- In most situations where the grapes are merely crushed or crushed and pressed, the CWM should receive a quotation of a sales tax registration number from the grape grower. This is because the grape grower will be undertaking a further manufacturing process with the crushed/pressed grapes and would be registered for sales tax purposes as a manufacturer.

- If the CWM crushes and presses grapes for use in its wine manufacturing activity, no sales tax liability arises as this process is part of the overall process of manufacturing wine.

TP 2 - Delivery of customer's materials goods

The CWM has manufactured commercially saleable wine from grapes supplied by the grape grower. When the bottled wine is delivered to the grape grower, a delivery of customer's materials goods has occurred. Sales tax is payable on this dealing if the grape grower does not quote a sales tax registration number.

Where grape growers will be selling this wine mainly by retail, they cannot quote. The CWM should therefore charge sales tax on these dealings. If more than 50% of the wine is to be sold by wholesale, the grape grower (if registered for sales tax purposes) may quote a sales tax registration number.

TP 3 - Delivery of customer's materials goods

The CWM has manufactured commercially saleable wine from grapes supplied by the grape grower. Even though the wine is still to be bottled, a delivery of customer's materials goods has occurred. Sales tax is payable on this dealing if the grape grower does not quote a sales tax registration number.

Where grape growers will be selling this wine mainly by retail, they cannot quote. The CWM should therefore charge sales tax on these dealings. If more than 50% of the wine is to be sold by wholesale, the grape grower (if registered for sales tax purposes) may quote a sales tax registration number.

TP 4 - Delivery of customer's materials goods

The CWM has manufactured raw wine from grapes supplied by the grape grower. Even though the raw wine is still to be processed into commercially saleable wine, a delivery of customer's materials goods has occurred. Sales tax is payable on this dealing if the grape grower does not quote a sales tax registration number.

It is expected that, in most situations, the grape grower will quote as the grape grower will be undertaking a further manufacturing process with the raw wine and would be registered for sales tax purposes as a manufacturer.

TP 5 - Wholesale sale

Retail sale

Application to own use (AOU)

If the grape grower quotes a registration number to the CWM on delivery of the wine, sales tax payable on the wine is deferred until a wholesale or retail sale of the wine or AOU of the wine occurs.

If the grape grower pays sales tax on delivery of the wine, a further sales tax liability only arises if the wine is sold by wholesale. The grape grower is required to pay sales tax on the wholesale sale but receives a credit for the tax paid on the earlier transaction.

TP 6 - Wholesale sale

Retail sale

Application to own use (AOU)

The grape grower has received raw wine from the CWM. From the raw wine, the grape grower has produced commercially saleable wine. Because the grape grower has manufactured new goods (commercially saleable wine), sales tax is payable on any wholesale or retail sale of the commercially saleable wine or AOU of the wine.

**Communication
of the Decision**

This draft Determination has been made available for publication by the sales tax publishing houses and has been mailed directly to relevant industry associations known to the ATO.

Your comments

If you wish to comment on this draft Determination, please send your comments by 11 September 1998 to:

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