



PR 2001/129 - Income tax: Specific Vineyard Project No. 3

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 This document has changed over time. This is a consolidated version of the ruling which was published on *26 September 2001*



Product Ruling

Income tax: Specific Vineyard Project No. 3

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

Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

No guarantee of commercial success

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

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

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

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

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

Terms of Use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Specific Vineyard Project No. 3, or 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);
 - Part 2-25 (ITAA 1997)
 - Section 44 of the *Income tax Assessment Act 1936* ('ITAA 1936');
 - Section 82KL (ITAA 1936);
 - Section 82KZL (ITAA 1936);
 - Section 82KZME (ITAA 1936);
 - Section 82 KZMF (ITAA 1936);
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling all fees and expenditure referred to include Goods and Services Tax ('GST') where applicable. In order for an entity (referred to in this Ruling as a 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 are more specifically identified in the Ruling part of this Product Ruling and 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; and
- persons who elect to be STS taxpayers (see paragraph 39 below).

Qualifications

9. The Commissioner rules on the precise arrangement identified in the Ruling. If the arrangements described in the Ruling are

materially different from the arrangements that are actually carried out:

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

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Date of effect

11. This Ruling applies prospectively from 26 September 2001, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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, this 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 2004. 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 from Specific Vineyard Management Ltd (the “Manager”) dated 1 May 2001;
- Draft Specific Vineyard Project No. 3 Prospectus undated;
- Draft Specific Vineyard Project No. 3 Second Supplementary Prospectus undated;
- Draft Constitution for Specific Vineyard Project No. 3 undated;
- Draft Supplementary Constitution for Specific Vineyard Project No. 3 undated;
- **Draft Grape Sale Agreement between the Grower and Brian McGuigan Wines Ltd (the “Buyer”) and Specific Vineyard Management Ltd (the “Responsible entity”) undated;**
- Draft Land Preparation and Development Agreement between Specific Vineyard 3 Ltd (the “Landowner”) and Specific Vineyard Management Ltd (the “Responsible Entity”) undated;
- **Draft Management and Maintenance Agreement between Specific Vineyard Management Ltd (the “Responsible Entity”) and the Grower undated;**
- **Draft Vineyard Agreement between Specific Vineyard Management Ltd (the “Responsible Entity”) and the Grower undated;**
- Draft Vineyard Development and Management Agreement between Specific Vineyard Management Ltd (the “Responsible Entity”) and Brian McGuigan Wines Ltd (the “Contractor”) undated; and
- Additional information furnished in a fax dated 30 May 2001 and e-mails dated 30 May 2001 and 12 June 2001.

Note: certain information 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 Growers enter into for the purposes of describing the arrangement to which the ruling

applies. There are not 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. The effect of these agreements is summarised as follows.

Overview

16. The arrangement is called Specific Vineyard Project No. 3

Location	Riverland wine-grape growing region in South Australia – Kingston-on-Murray
Type of business each participant is carrying on	Commercial growing and harvesting of grapevines for the sale of the fruit
Number of hectares to be under cultivation	223 hectares.
Size of each Leased Area	0.4 hectare
Number of trees per hectare	Approximately 1973 trees per hectare
Minimum Subscription	150 Vineyard Entitlements
Expected production during early years	3.0 tonnes per acre in the year ended 30 June 2004 rising progressively to 8.25 tonnes per acre in the year ended 30 June 2007
Term of the investment	Approximately 15 years
Initial cost	\$6237
Initial cost per hectare	\$15593
Ongoing costs	Licence Fees Management Fees Maintenance Fees
Other costs	Manager is entitled to any proceeds from grapes harvested prior to 30 June 2004

17. Growers participating in the project will enter into a Vineyard Agreement, a Management and Maintenance Agreement and a Grape Sale Agreement for the Project. These Agreements are set out in schedules to the Constitution. The Vineyard Agreement gives a Grower a licence over an identifiable area of land called a Vineyard Lot until the Project is terminated pursuant to the provisions of the Constitution. Each Vineyard Lot is approximately 0.4 hectares in size and has water rights attached.

18. The Project land is located about 10kms west of the township of Loxton in the Riverland district of South Australia. It is owned by Specific Vineyard 3 Ltd. It is sublet by Specific Vineyard 3 Ltd to Specific Vineyard Management Ltd. Specific Vineyard Management Ltd will grant to the Grower, by way of a licence, rights over an identifiable area of land called a "Vineyard Lot" to enable the Grower to carry on a long term commercial viticultural business. The Project is for a period of approximately fifteen years.

19. Each Vineyard Lot will contain approximately 800 grapevines. The Specific Vineyard Project No. 3 prospectus states that the minimum subscription for this Project is 150 Vineyard Entitlements which must be sold within 4 months of the date of the Prospectus and a maximum of 550 Vineyard Entitlements which must be sold by 30 November 2011. Each investor must subscribe for a minimum of four Vineyard Entitlements at a total initial cost of \$44,948. Each Vineyard Entitlement is structured as a split ownership and includes one Landowner's interest and one Grower's Interest.

20. Projected returns are subject to the inherent risks of primary production and the commercial risks of a long term venture of cultivating, growing harvesting, and sale of grapes. The risks associated with the project have been outlined in the Prospectus. Growers will execute a Power of Attorney enabling the Manager to act on their behalf as required when they make an application for an Allotment.

21. The Grower engages the Manager to cultivate and maintain the Vineyard Lot, to harvest and sell the Grapes produced. The Grower and the Responsible Entity will enter into a Grape Sale Agreement with the Buyer. The Buyer has agreed to purchase all of the grapes produced from the Grapevines grown on the Vineyard Lot, for the term of the Grape Sale Agreement.

Constitution

22. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Growers and to manage the Project. The Responsible Entity will keep a register of Growers (clause 14). Growers are entitled to assign their interests in certain circumstances (clause 18). The Management and Maintenance Agreement is attached to the Constitution (schedule 6) and will be executed on behalf of the 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

23. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Act. Under the Compliance Plan, a Compliance Committee will monitor to what extent the Responsible Entity meets its obligations as the Responsible entity and the rights of the Growers are protected.

Interest in land

24. A licence is granted by the Responsible Entity to Growers under the terms of the Vineyard Agreement. Growers are granted an interest in land in the form of a licence to use their Vineyard Lots for the purpose of conducting their viticultural business (cl 2.1 of the Vineyard Agreement).

25. Each Grower must pay a fee to the Responsible Entity being an amount specified in clause 7.1 of the Vineyard Agreement. The term of the Grower's licence is until the project is terminated pursuant to the provisions of the Constitution being the termination of the Grower's Interest or 30 June 2016 whichever happens first. This is estimated as occurring approximately 15 years after the commencement of the Project.

26. Under the terms of the Vineyard Agreement, among other things, the Grower:

- must use the Grower's Allotment solely for the purpose of establishing, maintaining and harvesting the grapes;
- must comply with the best viticultural practices adopted within the grape producing industry;
- must comply with all laws and regulations relating to the use and occupancy of the Grower's Allotment;
- take all reasonable measures to prevent and combat land degradation on the Grower's Allotment; and
- take all reasonable steps to avoid interfering with the activities carried out on neighbouring land by the owner or occupier of that land.

Management and Maintenance Agreement

27. Each Grower enters into a Management and Maintenance Agreement with the Responsible Entity for each Vineyard Lot. The Agreement establishes the Project and operate as a contract binding on all of the Growers of the Project and the Responsible Entity. Under the Agreement the Grower appoints the Manager to cultivate,

maintain, harvest, and sell the Grapes from the Grower's Vineyard Lot.

28. The Vineyard Agreement and the Management and Maintenance Agreement set out the terms and conditions under which Specific Vineyard Management Ltd agrees to act as Manager and thereby manage the Project. The Vineyard Agreement and the Management and Maintenance Agreement 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 Vineyard Agreement and the Management and Maintenance Agreement by virtue of their participation in the Project. Growers may assign their interest only in certain circumstances as set out in clause 18 of the Project Constitution.

29. The Agreement commences on the date the Management and Maintenance Agreement is executed by the Manager. The Project is terminated pursuant to the provisions of the Management and Maintenance Agreement the earlier of the termination of the Grower's Interest or 30 June 2016 (clause 3 of the Management and Maintenance Agreement).

30. The Responsible Entity must :

- tend the Vines in a proper and skilful manner including pruning at the proper time;
- harvest the grapes on the Vineyard at the time specific in the agreement; and
- manage the Vineyard in order to optimise the return of grapes for the production of premium table wines.

31. The Project does not involve guaranteed returns or non-recourse financing. There are no risk reduction mechanisms or express or implied undertakings to reverse the transactions if tax deductions are not allowed by the Commissioner.

Fees

32. The fees payable under the Vineyard Agreement and the Management and Maintenance Agreement, on a per Vineyard Lot basis, are as follows:

- **The Subscription Sum** is payable by each Grower for the period from the Commencement Date to 30 June 2002 in two equal instalments on 31 December 2001 and 30 June 2002 respectively. Execution of the Agreement takes place on or after 30 June 2001. The Subscription Sum is made up of a

\$4,752 Maintenance Fee, a \$550 Management Fee and a \$935 Licence Fee.

In all other years:

- **Maintenance Fees** are payable to the Responsible Entity in two instalments, on 31 December and 30 June, for performing the Services during the relevant year;
- after the First Period the Maintenance Fee payable is \$4257 for the year ended 30 June 2003, \$3094 for the year ended 30 June 2004 and \$2904 for the year ended 30 June 2005;
- for the year ended 30 June 2005 and subsequent years the Maintenance Fee is the fee for the previous year indexed to the CPI (to a maximum of 5%);
- **Management Fees** are payable to the Responsible Entity in two instalments, on 31 December and 30 June, for performing the Services during the relevant year;
- after the First Period a Management Fee of \$550 is payable for each Financial Year up to and including 30 June 2004;
- for the year ended 30 June 2005 and subsequent years a Management Fee of 8% of the gross proceeds due to the Grower under the Grower's Grape Sale Agreement is payable;
- after the First Period a Licence Fee equal to the fee for the previous year increased by 5% is payable;
- premiums for insurance cover against destruction or damage by fire, arranged by the Manager if requested by the Grower.

33. Under the terms of the Constitution all moneys received from applications shall be paid to the Responsible Entity. The Responsible Entity may transfer money paid by an Applicant from the Application Fund when specific conditions are satisfied. (clause 15).

Harvesting

34. The Grower has full right, title and interest in the Grapes that are produced by the Grower in the Vineyard Lot (clause 3.2). The Grape Vines will remain the property of the Landowner. The Responsible Entity will arrange the harvesting and sale of the Grapes.

35. The Responsible Entity will harvest the Grapes on the Grower's Allotment to optimise the return of grapes for the production

of premium quality table wines (clause 4). The proceeds from the Vineyard Lots will be pooled pursuant to clause 8.

36. In accordance with the Constitution the Responsible Entity must pay the proceeds it receives into the Proceeds Fund of the Project (clause 3.2) A Grower is entitled to the money in the Proceeds Fund which represents the gross income from that Grower's Grapes Attributable to the Grower's Vineyard Lot for a particular Production Period, less:

- (i) all fees payable under the Grower's Management and Maintenance Agreement;
- (ii) all fees payable under the Grower's Vineyard Agreement; and
- (iii) all other amounts payable by the Grower under the Constitution, the Grower's Vineyard Agreement and the Management and Maintenance Agreement.

Finance

37. Growers can fund their investment in the Project themselves, or borrow from an independent lender.

38. This Ruling does not apply if a Grower 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 Grower's for the Project.

Ruling

Simplified Tax System ('STS') and the non-application of this Ruling to 'STS taxpayers'

39. At the request of the applicant, this Ruling does not rule on any tax laws in new Division 328, concerning 'STS taxpayers'. 'STS taxpayers are those who are both eligible and elect to become subject to the special rules in Division 328 to do with the Simplified Tax System. These taxpayers will, therefore, not be covered by this Ruling but can ask for a private ruling on how Division 328 applies to their involvement in the arrangement covered by this Ruling.

Assessable Income

40. 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.

41. Once harvested, a Grower's fruit will be trading stock of the Grower. As a consequence, if fruit is on hand at the end of an income year, the Grower will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of the ITAA 1997. Each Grower will be notified by the Manager of the relevant amounts to be brought to account in respect of their proportional interest in the Project, in accordance with Part 2-25.

42. Dividends received from Specific Vineyard 3 Ltd will be assessable under section 44.

Minimum subscription

43. Growers will not incur the fees shown in the Table below before the minimum subscription for the Project is reached and the Grower's application to enter the Project is accepted (the date the investment is made). Under the prospectus, a Grower's application will not be accepted and the Project will not proceed until the minimum subscription of 150 Vineyard Entitlements is achieved. Tax deductions are not allowable until these requirements are met.

Section 8-1**Deductions where a Grower is not registered nor required to be registered for GST**

44. A Grower may claim tax deductions in the Table(s) below where the Grower :

- participates in the Project by 30 June 2002 to carry on the business of growing grapes;
- incurs the fees shown in paragraph 32; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	2002 deductions	2003 deductions	2004 deductions
Maintenance Fee	8-1	\$4,752 – see Note (i) (below)	\$4257 - see Note (i) (below)	\$3094 - see Note (i) (below)
Management Fee	8-1	\$550 – see Note (i) (below)	\$550 - see Note (i) (below)	\$550 – see Note (i) (below)
Licence Fee (Rent)	8-1	\$935 – see Note (i) (below)	\$982 - see Note (i) (below)	\$1031 - see Note (i) (below)
Interest	8-1	See Note (ii) below	See Note (ii) below	See Note (ii) below

Notes:

- (i) Where a Grower incurs maintenance fees, management or the licence fees as required by the Management and Maintenance Agreement and the Vineyard Agreement those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of a thing (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, the prepayments rules of the ITAA apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula in subsection 82KZMF(1) (see paragraph 84) unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and is deductible in full in the year in which it is

incurred. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than \$1,000.

- (ii) The deductibility or otherwise of interest arising from loan agreements entered into with financiers 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 paragraphs 76 to 84 below as those rules may be applicable if interest is prepaid. The prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower's choice.

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

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

- participates in the Project by 30 June 2002 to carry on the business of growing grapes;
- incurs the fees shown in paragraph 32; 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 97.

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

Section 35-55 – Commissioner's discretion

46. For a Grower who is an individual and who enters the Project during the year ended 30 June 2002 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 2002 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.

47. 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).

48. 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.

49. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, 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 this perspective has not been made.

Sections 82KZME – 82KZMF, 82KL and Part IVA

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

- 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.

Part 3-1: capital gains tax

51. Each Grower or an associate has the right to subscribe for 5000 \$1 shares in the Landowning Company respect of each Vineyard Lot acquired by the Grower. Unless any shares in that company are trading stock of the Grower or otherwise assessable on revenue account to the Grower, a capital gain or loss will arise on the sale of those shares.

52. In the event that the Landowning Company is liquidated at the conclusion of the Project, further taxation considerations arise for the

Grower holding shares in the company. Any distribution made to a Grower on liquidation of the company would be deemed to be a dividend to the Grower, to the extent of the company's undistributed profits. This dividend would be assessable as a normal dividend and may have franking credits attached. Further, a capital gain or loss could arise, based on the difference between the Grower's cost base and the amount distributed in accordance with the provisions of Part 3-1 of the ITAA 1997.

Explanations

Section 8-1

53. Consideration of whether the management fees and the lease fees are deductible under section 8-1, begins with the first limb of the section. This view 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 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 that 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 the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

Is the Grower carrying on a business?

54. A viticulture scheme can constitute the carrying on of a business. Where there is a business, or a future business, the Gross Harvest Proceeds each year from grapes from vinelots comprising the Project will constitute gross 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 vinelot. 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 grapes each year 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.

55. For this Project Growers have rights under the Vineyard Agreement in the form of a licence over an identifiable area of land consistent with the intention to carry on a business of growing grapes. Under the Management and Maintenance Agreement Growers engage the Project Manager to acquire vine seedlings and plant out the seedlings on the Allotment and to provide ongoing services to care and maintain the vines. Growers are considered to have control of their operations.

56. The Vineyard Agreement provides Growers with more than a chattel interest in the grapes. The Project documentation contemplates Growers will have an ongoing interest in the grapes.

57. Growers have the right to use the land in question for viticulture purposes and to have the Project Manager come onto the land to carry out its obligations under the Management and Maintenance Agreement. The Grower's degree of control over the Project Manager as evidenced by the Management and Maintenance Agreement, and supplemented by the Corporations Act, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Project Manager's activities. Growers are able to terminate arrangements with the Project Manager in certain instances, such as cases of default or neglect. The viticulture activities described in the Management and Maintenance Agreement are carried out on the Grower's behalf.

58. 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 application 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.

59. Growers will engage the professional services of a manager with appropriate credentials. There is a means to identify which grapes Growers have an interest in. These services are based on

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

60. 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 Grower's viticulture activities will constitute the carrying on of a business.

61. The licence fees, maintenance fees 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 income (from the regular sale of grapes) 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 the first limb of section 8-1 are met. The exclusions do not apply.

Possible application of the prepayment provisions

62. Under the Management and Maintenance Agreement and the Vineyard Agreement neither the management and maintenance fees nor the licences fees are for things to be done beyond 30 June in the year in which the relevant amounts are incurred. In these circumstances, the prepayment provisions in section 82KZME and 82KZMF have no application to these fees.

63. However, where a Grower chooses to prepay these fees for a period beyond the income year in which the expenditure is incurred, the prepayment provisions (see paragraphs 79 to 92) will apply to determine the amount and timing of the deductions. This is subject to the 'excluded expenditure' exception. For the purposes of this Ruling 'excluded expenditure' refers to an amount of expenditure less than \$1,000.

Timings of deductions

64. In the absence of any application of the prepayment provisions, the management and maintenance fees and the license fees are deductible in the year they are incurred.

Division 35 – Deferral of 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 four interests in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2005. Growers who acquire more than four interests 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 46), in the manner described in the Arrangement (see paragraphs 14 to 38), 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 provided with the application by the Responsible Entity;

- the binding Grape Sale Agreement contract with Brian McGuigan Wines Ltd for the sale of the grapes setting out prices that realistically reflect the existing market and/or the projected market in the geographical region where the grapes are grown;
- independent, objective, and generally available information relating to the viticulture industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Interest deductibility

76. 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.

77. 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. Alternatively, a Grower may choose to prepay such interest. Unless such prepaid interest is 'excluded expenditure' any tax deduction that is allowable will be subject to the prepayment provisions of the ITAA 1936 (see paragraphs 84 to 97).

Prepayment provisions

78. The object of the prepayment provisions in sections 82KZL to 82KZMF is to apportion certain prepaid expenditure. Where they apply, they override the general rule in section 8-1 that a deduction is allowed when incurred.

79. For this Project only section 82KZL (an interpretive provision) and sections 82KZME and 82KZMF are relevant. Where the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1).

Sections 82KZME and 82KZMF

80. Where the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing

of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

81. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer's allowable deductions under the agreement for the 'expenditure year' exceed any assessable income attributable to the agreement for that year; and
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and
- either :
 - (a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - (b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

82. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)). This has particular relevance for a Grower in this Project who may borrow funds from an external financier in order to participate in the Project. Although undertaken with an unrelated party, that financing would be an element of the arrangement. The funds borrowed and the interest deduction are directly related to the activities under the arrangement. If a Grower prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF.

83. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than \$1,000. Such expenditure is immediately deductible.

84. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion the relevant prepaid expenditure. Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

Expenditure X Number of days of eligible service period in the year of income
Total number of days of eligible service period

In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Application of the prepayment provisions to this Project

85. In this Project, an initial Management Fee of \$550, Maintenance Fee of \$4752 and an initial Lease Fee of \$935 per Allotment will be incurred on 31 December 2001 and 30 June 2002. The Management Fee, Maintenance Fee and the Lease Fee are charged for providing management services, maintenance services or leasing land to a Grower by 30 June of the year of execution of the Agreements. Under the agreements, further annual expenditure is required each year during the term of the Project for the provision of management services and land until 30 June in those years.

86. 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 initial Management Fee has been inflated to result in reduced fees being payable for management fees in subsequent years.

87. There is also no evidence that might suggest the management services covered by the fee could not be provided within the relevant expenditure year. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial Management fee, and the fees for subsequent years, is for the Manager doing 'things' that are not to be wholly done within the expenditure year. Under the Lease agreement, lease fees are payable annually in advance for the lease of the land during the expenditure year.

88. On this basis, provided a Grower incurs expenditure as required under the Project agreements, as set out in paragraph 45, then the basic precondition in subsection 82KZME(2) is not satisfied and, in these circumstances, section 82KZMF will have no application.

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

89. Although not required under either the Management Agreement or the Lease Agreement a Grower participating in the Project may choose to prepay fees for a period beyond the

‘expenditure year’. Similarly, Growers who borrow to fund their investment may either choose, or be required to prepay interest. Where this occurs, contrary to the conclusion reached in paragraph 94 above, section 82KZMF will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

90. For these Growers, the amount and timing of deductions for any relevant prepaid Management Fees, prepaid Lease Fees, or prepaid interest will depend upon when the respective amounts are incurred and what the ‘eligible service period’ is in relation to these amounts.

91. However, as noted above, prepaid fees of less than \$1,000 incurred in an expenditure year will be ‘excluded expenditure’ and will be not subject to apportionment under section 82KZMF.

Section 82KL - recouped expenditure

92. 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

93. 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).

94. The Specific 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 paragraphs 44 and 45 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.

95. 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 grapes. 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.

Examples

Example 1 – Entitlement to ‘input tax credit’

96. 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’ 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:

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

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

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

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Commissioner of Taxation

26 September 2001

Previous draft:

Not previously issued in draft form

- tax shelters

- tax shelters project

Related Rulings/Determinations:

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

Legislative references:

- ITAA 1997 Part 2-25
 - ITAA 1997 Part 3-1
 - ITAA 1997 Div 328
 - 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

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

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| - ITAA 1997 35-55(1) | - ITAA 1936 82KZME(4) |
| - ITAA 1997 35-55(1)(a) | - ITAA 1936 82KZME(7) |
| - ITAA 1997 35-55(1)(b) | - ITAA 1936 82KZMF |
| - ITAA 1936 44 | - ITAA 1936 82KZMF(1) |
| - ITAA 1936 82KL | - ITAA 1936 Pt IVA |
| - ITAA 1936 82KZL | - ITAA 1936 177A |
| - ITAA 1936 82KZL(1) | - ITAA 1936 177C |
| - ITAA 1936 82KZME | - ITAA 1936 177D |
| - ITAA 1936 82KZME(1) | - ITAA 1936 177D(b) |
| - ITAA 1936 82KZME(2) | - TAA 1953 Part IVAAA |
| - ITAA 1936 82KZME(3) | |
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