PR 2001/41 - Income tax: Magpie Ridge Vineyards Project

Product Ruling
Income tax: Magpie Ridge Vineyards Project

Contents Para

What this Product Ruling is about 1
Date of effect 11
Withdrawal 13
Arrangement 14
Ruling 44
Explanations 53
Example 118
Detailed contents list 119

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 Magpie Ridge Vineyards Project, 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 42-15 (ITAA 1997);
- section 42-125 (ITAA 1997;
- section 387-55 (ITAA 1997);
- section 387-125 (ITAA 1997);
- section 387-165 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL (ITAA 1936);
- section 82KZM and 82KZMB - 82KZMF (ITAA 1936); and
- Part IVA (ITAA 1936).

Goods and Services Tax

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

Business Tax Reform

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change, those changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

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

Note to promoters and advisers

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

Class of persons

7. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires) and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

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

Qualifications

9. 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.

Date of effect

11. This Ruling applies prospectively from 11 April 2001, 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 20 October 2000;
- The Magpie Ridge Vineyards Project Draft Prospectus, undated;
- **Amended Draft Lease and Management Agreement** between Norfolk Ridge Vineyards Ltd (the 'Responsible Entity'), NR Properties Ltd (the 'Lessor') and the Grower dated 16 February 2001;
- Draft Constitution between Norfolk Ridge Vineyards Ltd and NR Properties Ltd; and
- Draft Compliance Plan.

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

15. The documents highlighted are those the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of the Grower, will be a party to, with the exception of finance agreements to which paragraphs 42 and 43 apply. The effect of these agreements is summarised as follows.

Overview

16. This arrangement is called the Magpie Ridge Vineyards Project.

Location	South West Region of Western Australia, near Mt Barker.
Type of business each participant is carrying on	A long term commercial viticulture business.
Number of hectares under cultivation	22 hectares
Name used to describe the product	Magpie Ridge Vineyards
Size of each Leased Area	0.16 hectares
Number of vines per hectare	1,850
Expected production	12 tonnes/hectare
The term of the investment in years	15 years
Initial cost	$5.610
Initial cost per hectare	$35,063
Ongoing costs	Annual Management Fees and Rent.

17. Growers applying under the Draft Prospectus enter into a Lease and Management Agreement. The arrangements are set out in the Constitution for the Project. The Lease and Management Agreement gives a Grower a lease over an identifiable area of land called a 'Leased Area' until the Project is terminated on 31 December 2015. The term of the Project is expected to be 15 years. Each Leased Area is 0.16 hectares in size.

18. The Project Land is situated in the South West Region of Western Australia, near Mt Barker. NR Properties Ltd owns the land.

19. NR Properties Ltd will lease the Leased Area to the Grower for the purpose of carrying on a long term commercial viticulture project.

20. There is no minimum subscription. Each investor may subscribe for a minimum of one Leased Area. The Responsible Entity will plant approximately 296 vines per Vinelot (1,850 per hectare) during the period up to 31 May 2001 following the execution of the Lease and Management Agreement.

21. Possible projected returns for Growers are outlined at pages 11 and 12 of the Draft Prospectus. The Responsible Entity does not guarantee the success of the vineyard. Investors will be exposed to the usual business risks and agricultural risks inherent in primary production due to matters beyond the control of the Responsible Entity such as adverse weather conditions, insect attacks and variable market conditions. The projected returns are subject to the inherent risks of the long term nature of the venture. Norfolk Ridge Vineyards Ltd and NR Properties Ltd have outlined these risks in the Draft Prospectus for the Project.

22. Growers will execute a Power of Attorney enabling the Responsible Entity, Norfolk Ridge Vineyards Ltd, to act on their behalf as required when they make an application for a Leased Area.

Constitution

23. 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. Growers are entitled to assign their Grower's Interest in certain circumstances. The Lease and Management Agreement will be executed on behalf of Growers following their signing of the Application and a Power of Attorney Form attached to the Offer Information Statement. Growers are bound by the Constitution and the Lease and Management Agreement by virtue of their participation in the Project.

Interest in land

24. A lease is granted by the Lessor to each Grower under the terms of the Lease and Management Agreement (cl. 3.1). Growers are granted an interest in land in the form of a lease to use their Leased Area for the purpose of long term viticulture and the Project (cl. 5.2). Growers must pay rent annually to the Lessor for the term of the lease which is from the Commencement Date until 31 December 2015.

Lease and Management Agreement

25. Each Grower enters into a Lease and Management Agreement with the Responsible Entity. The termination of the Project is the date on which the last of the Growers has been advised that the grape produce of the 2014/2015 crop from each leased area which is leased by the Grower has been harvested and that the relevant Lease and Management Agreement has been terminated but, in any event, no later than 31 December 2015 (cl. 42 of Constitution). Growers contract with the Responsible Entity to plant, develop, manage and maintain the vines. Growers pay an Initial Management Fee on application and annual Management Fees thereafter.

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

- Plant suitable callused cuttings or vine rootlings on the leased area;
- Cultivate, tend, train, prune, fertilise, spray, and otherwise care for the vines as and when required;

- Use all reasonable measures to keep the leased area free from vermin, noxious weeds, pests and diseases;
- Maintain the leased area according to good viticultural practices; and
- Replace any vines that fail to establish or that die during the first three years of the project.

27. Growers may elect to collect and market their own collectable produce. However, where no election is made, the Responsible Entity will harvest (cl. 17) from the date of the first commercially harvestable grape crop the grape produce grown on the vineyard at such time or times as, in the opinion of the Responsible Entity, will maximise the price receivable for such grape produce for the purpose of making quality wines. The Responsible Entity will be responsible for paying for the annual cost of public liability insurance on the Leased Area (cl. 21.1). The Grower will be responsible for additional insurances as required by the Grower such as vine and crop protection (cl. 21.2).

28. Applications for Leased Areas will not be accepted after 31 May 2001.

Fees

29. The Growers will make the following payments in respect of each vineyard allotment for the three years first commencing during the year ended 30 June 2001.

30. The initial amount payable on application under the Lease and Management Agreement for the Project is $5,610 per Leased Area. This amount includes the Management Fee of $4,125 which is payable in two instalments. The first instalment of $1,100 is payable on application and the second instalment of $3,025 is payable either on application or 31 May 2001, whichever is the later. The balance of the initial amount payable on application is made up of the cost of Irrigation of $1,375 and Rent of $110 (schedule to the Lease and Management Agreement). The services included in these fees will be provided by 30 June 2001.

31. A Management Fee of $3,850 and fees of $1,210, for Trellising, and $220 for establishing Rootlings are payable for services to be carried out in the period 1 July 2001 to 30 June 2002. The fees are payable by 30 September 2001.

32. Annual Management Fees of $1,980 are payable for services to be carried out for the periods 1 July 2002 to 30 June 2003 and 1 July 2003 to 30 June 2004 and are payable on 30 September of the relevant year. Commencing on 1 July 2004, an indexed annual Management Fee is payable for the period 1 July to 30 June of each

year. These Management Fees are also payable on 30 September in the relevant year. The amount of the annual Fee will be the amount for the immediately preceding year, increased by the greater of 3% or the percentage increase in the Consumer Price Index between the March quarter in the year of payment and the March quarter in the immediately preceding year.

33. Under the Lease and Management Agreement, each Grower agrees to pay to the Responsible Entity a bonus equivalent to 50% of the value of grape produce received each year in excess of the projected total returns per Leased Area set out in the Prospectus (cl. 22.1.3).

34. A Grower may in each year after Year 5 (the period 1 July 2005 to 30 June 2006) of the arrangement, elect to pay a reduced management fee equivalent to 50% of the management fee and in consideration grant and agree to pay an additional bonus to the Responsible Entity equivalent to 50% of the value of grape produce received each year in excess of the projected total returns per leased area set out in the Prospectus.

35. Rent of $330 is payable by the Grower on 30 September 2001, for the period ended 30 June 2002. Rent of $330 is payable by the Grower for the periods 1 July 2002 to 30 June 2003 and 1 July 2003 to 30 June 2004 and is payable on 30 September in the relevant year.

Fee type	***Year 1 payments***	**Year 2 payments**	**Year 3 payments**
Management fees	$4,125	$3,850	$1,980
Rent	$110	$330	$330
Irrigation	$1,375		
Trellising		$1,210	
Rootlings		$220	

36. Rent of $330 per year, indexed annually from 1 July 2004, is payable by the Grower on 30 September each year. The amount of the annual Rent will be the amount for the immediately preceding year, increased by the greater of 3% or the percentage increase in the Consumer Price Index between the March quarter in the year of payment and the March quarter in the immediately preceding year.

37. There is no Viticulturist's report for this project.

38. The Subscription Monies will be held in the Trust Account by the Responsible Entity under the Project's Constitution (cl. 9.6).

Planting

39. The Responsible Entity will be responsible for planting suitable callused cuttings or vine rootlings on the leased area. The Responsible Entity will maintain the leased area according to good viticultural practices. The services to be provided by the Responsible Entity over the term of the project are outlined in the Lease and Management Agreement (Item 9 of schedule).

Harvesting

40. The Responsible Entity will be responsible for the harvesting of the grape produce grown on the vineyard. The Harvest will commence from the date of the first commercially harvestable grape crop from the vineyard at such time or times as, in the opinion of the Responsible Entity, will maximise the price receivable for such grape produce for the purpose of making quality wines.

41. The Receipts from the sale of any grape produce sold by the Responsible Entity on behalf of Growers who have not elected to collect and market their collectable produce will be paid into one or more produce funds established by the Responsible Entity. Receipts received by the Responsible Entity are to be distributed in the following order of priority:

- any annual contributions payable by a non-electing Grower that are due and unpaid (cl. 20.3.1 of Lease and Management Agreement);
- payment of the portion of the Responsible Entity's bonus payable under clause 22.1.3 of Lease and Management Agreement (cl. 20.3.2 of Lease and Management Agreement);
- payment of the Responsible Entity's Additional Bonus payable under clause 22.1.4 of Lease and Management Agreement (cl. 20.3.3 of Lease and Management Agreement);
- any amount payable by a non-electing Grower to the Responsible Entity under the Lease and Management Agreement (cl. 20.3.4 of Lease and Management Agreement); and
- to the non-electing Grower in proportion to their respective proportional interest in the net sales proceeds (cl. 20.3.5 of Lease and Management Agreement).

Finance

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

43. 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 Growers for the Project.

Ruling

Assessable income

44. 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 of the ITAA 1997. Section 17-5 of the ITAA 1997 excludes from assessable income an amount relating to GST payable on a taxable supply. If grapes or grape juice are on hand at the end of the income year, the Grower will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of ITAA 1997.

Deductions where a Grower is not registered nor required to be registered for GST

45. A Grower may claim tax deductions using the methods and Tables in paragraphs 45 and 46 where the Grower:

- participates in the Project by 31 May 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 29-35, and
- is not registered nor is required to be registered for GST.

Fee type	ITAA 1997 section	Year 1 deductions	Year 2 deductions	Year 3 deductions
Management fees	Section 8-1	$4,125 – see note (i) below	$3,850 – see note (i) below	$1,980 – see note (i) below
Rent	Section 8-1	$110 – see note (ii) below	$330	$330
Interest	Section 8-1	As incurred – see notes (ii) & (iii) below	As incurred – see notes (ii) & (iii) below	As incurred – see notes (ii) & (iii) below

Notes:

(i) Where Management fees are prepaid, the fees are NOT deductible in full in the year incurred. The deduction for each year's fees must be determined using the formula shown in paragraph 49.

(ii) Amounts 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 amounts that exceed $999, such as may occur where a Grower acquires a number of interests in the Project, will be determined on the same basis as prepaid Management fees, i.e., using the formula shown in paragraph 49.

(iii) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, under the prepayment rules applying to the Project, 'agreement' is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. Therefore, all Growers who enter into agreements to finance their participation in the Project should read carefully the information provided in paragraphs 72 to 74.

Tax deductions for capital expenses

46. A Grower who invests in the Project by 31 May 2001 will also be entitled to the following tax deductions:

Fee type	ITAA 1997 section	Year 1	Year 2	Year 3
Trellising	42-15	See note (iv) below	See note (iv) below	See note (iv) below
Irrigation costs	387-125	\$459 - see note (v) below	\$458 - see note (v) below	\$458 - see note (v) below
Establishment of horticultural plants	387-165	Nil - see note (vii) below	Nil	Nil

Notes:

(iv) The tax deduction for depreciation of trellising will depend upon whether or not the Grower is a 'small business taxpayer' (see paragraphs 82 to 84 below).

For a Grower who is a 'small business taxpayer' and who complies with the conditions in section 42-345, the tax deduction for depreciation of trellising is determined using the rates in section 42-125 and the formula in either subsection 42-160(1) ('diminishing value method') or subsection 42-165(1) ('prime cost method'). The tax deduction calculated under these formulae depends upon the number of 'days owned', being the number of days in the income year in which the Grower owned an interest in the trellising, and the extent to which the trellising is installed ready for use during the year. The Project's manager is to advise Growers of relevant details to calculate their depreciation deductions for the year ended 30 June 2001. Depending upon the method the Grower elects to use, the rate for calculating the tax deduction will be 13% prime cost method or 20% diminishing value method.

Note: The depreciation deductions for 'small business taxpayers' discussed above apply until the introduction of the Simplified Tax System on 1 July 2001 (see paragraphs 79 to 81).

For a Grower who is NOT a 'small business taxpayer' or who is a 'small business taxpayer' who does not satisfy the conditions in section 42-345, the tax deductions for depreciation of trellising is determined using the formula in either subsection 42-160(3) ('diminishing value method') or subsection 42-165(2A) ('prime cost method'). The tax deduction calculated under these formulae depends upon the number of 'days owned', being the number of days in the income year in which the Grower owned an interest in the trellising, and the extent to which each is installed ready for use during the year. The formulae use 'effective life' rather than rate to determine the deduction for depreciation. The Project's manager is to advise Growers of relevant details to calculate their depreciation deductions for the year ended 30 June 2001. Note: This is only applicable to plant acquired after 21 September 1999 (see paragraphs 87 to 88).

A Grower who is NOT a 'small business taxpayer' has the option of allocating the trellising to a 'low value pool' and calculating the depreciation deduction under section 42-470 using the diminishing value method (see paragraphs 89 to 93 below). Note: This choice is only available from 1 July 2000.

(v) A deduction is allowable under section 387-125 for capital expenditure incurred for acquisition and installation of the irrigation system. The deduction is calculated on the basis of one third of the capital expenditure in the year in which the expenditure is incurred, and one third in each of the next 2 years of income.

(vi) A tax offset is available to certain low income primary producers under section 388-55 in respect of expenditure incurred on landcare operations and/or facilities to conserve or convey water. This is an alternative to claiming deductions under section 387-125.

(vii) A deduction is allowable under section 387-165 for capital expenditure incurred for the acquisition and establishment of grapevines for use in a horticultural business. The deduction is allowable when the grapevines, as horticultural plants, enter their first commercial season. If the grapevines have an 'effective life' for the purposes of section 387-185 of greater than '13 but fewer than 30 years', this results in a write-off rate of rate of 13% prime cost. The Project's manager will inform Growers of when the grapevines enter their first commercial season.

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

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

- participates in the Project by 31 May 2001 to carry on the business of growing grapes;
- incurs the fees shown in paragraphs 29 - 35; and
- is entitled to an input tax credit for the fees,

then the tax deductions calculated using the methods and Tables in paragraphs 45 and 46 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 118.

Sections 82KZM, 82KZMB – 82KZMD, 82KL and Part IVA

48. For a Grower 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 Growers does not fall within the scope of section 82KZM (but see paragraphs 63 – 71);

(ii) the expenditure by Growers does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 63 – 71);

(iii) the expenditure by Growers does not fall within the scope of sections 82KZME – 82KZMF (but see paragraphs 63 – 71);

(iv) section 82KL does not apply to deny the deductions otherwise allowable; and

(v) 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 Growers enter into does not require fees to be paid by Growers prior to the commencement of each eligible service period. If, however, a Grower 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, the tax deductions for the prepaid fee must be determined using the formula shown below (see paragraphs 67 to 71).

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

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

50. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001, the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2005 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

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

- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies (see paragraph 103 in the Explanations part of this ruling, below).

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.

52. Where either the Grower's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not

apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

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 taxpayers contractually commit 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 Sale 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.

55. 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.

56. For this Project Growers have rights under the Lease and Management Agreement in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing vines. Under the Lease and Management Agreement Growers engage the Project Managers to acquire vine rootlings and plant out the rootlings on the leased land and provide ongoing services to care and maintain the vines. Growers control their operations.

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

58. 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 Lease and Management Agreement. The Growers' degree of control over the Project Manager as evidenced by the Lease and Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Project 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 Lease and Management Agreement are carried out on the Growers' behalf.

59. 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 Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

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

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

61. Growers have a continuing interest in the vines from the time they are acquired until the cessation of the Project. The viticulture activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' viticulture activities will constitute the carrying on of a business.

62. The lease 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 the 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.

Sections 82KZM and 82KZMB – 82KZMD

63. The prepayments provisions operate to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1 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.

64. Under the Lease and Management Agreement, fees of $4,125 per Vinelot will be incurred on the execution of the Agreement. The fees are charged for providing services to a Grower 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.

65. 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 fee is for the Project Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, the basic precondition for the operation of the prepayments provisions is not satisfied and it will not apply to the expenditure incurred by the Grower.

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

Prepaid fees

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

68. Where a Grower 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 prepayments 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 Grower is a 'small business taxpayer'.

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

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

70. Although not required under the Arrangement described in this Product Ruling, where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a small business taxpayer or section 82KZMD if the Grower is not a small business taxpayer. For 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 69 above, concerning section 82KZMF.

71. Prepaid Lease fees of less than $1,000 in each expenditure year is ‘excluded expenditure’ as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(7) and 82KZMA(4) all provide that ‘excluded expenditure’ is an exception to the prepayment rules discussed above. Therefore, a prepaid fee of less than $1,000 is deductible in full in the year in which it is incurred. However, where a Grower acquires more than one interest in the Project and the quantum of 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

72. 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.

73. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in sections 82KZME, ‘agreement’ (defined in subsection 82KZME(4)) is a broad concept and 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.

74. 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) that may be allowable. Where a prepayment is for more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a ‘small business taxpayer’) or section 82KZMD (for a taxpayer who is not a ‘small business taxpayer’). The relevant formula is the same as that shown in paragraph 69 above.

Expenditure of a capital nature

75. Any part of the expenditure of a Grower entering into a viticultural business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, the costs of irrigation and the establishment of horticultural plants are considered to be capital in nature. The fees for these expenditures are not deductible under section 8-1. However, some of

this expenditure falls for consideration under specific write-off provisions of the ITAA 1997.

Section 42-15 - depreciation of trellising

76. Under section 42-15, taxpayers can deduct an amount for depreciation of a unit of plant used for the purpose or purposes of producing assessable income where they are the owners or quasi-owners of that plant. However, where an item is affixed to land so that it becomes a fixture, at common law it becomes part of the land and is legally absolutely owned by the owner of the land.

77. It is, however, accepted in certain circumstances that lessees are entitled to claim depreciation where they are considered to be the owner of those improvements. Taxation Ruling IT 175 sets out the Australian Taxation Office's (ATO's) views on this issue. Where lessees are considered to own the improvements under a state law, as detailed in the Ruling, or where they have a right to remove the fixture or are entitled to receive compensation for the value of the fixture, the ATO accepts that lessees are entitled to claim depreciation for the fixture.

78. Under section 42-15 Growers in the Project are entitled to depreciation deductions for capital expenditure in relation to the acquisition and installation of trellises on the land. The deduction available, however, will depend upon the date the investment is made, when the plant is installed ready for use and whether or not a Grower is a 'small business taxpayer' (see paragraphs 82 to 84).

79. For plant acquired or constructed after 11:45am by legal time in the Australian Capital Territory on 21 September 1999, accelerated rates of depreciation are no longer available except to some 'small business taxpayers'. The Government has announced that 'small business taxpayers' who meet the conditions in section 42-345 will have access to accelerated rates of depreciation until the introduction of the proposed Simplified Tax System on 1 July 2001.

80. The immediate deduction for items of plant costing $300 or less has been removed from 1 July 2000, except for 'small business taxpayers'. The Government has announced that 'small business taxpayers' will be able to claim the immediate deduction until the introduction of the proposed Simplified Tax System.

81. The depreciation of trellising as explained in this Product Ruling is based on existing legislation and may be subject to change.

Small business taxpayers

82. 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.

83. '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).

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

Depreciation deductions for Growers who are 'small business taxpayers'

85. The depreciation deduction for trellising available to a Grower who is a 'small business taxpayer' and who complies with the conditions contained in section 42-345 is calculated using the formula in either subsection 42-160(1) or subsection 42-165(1). The depreciation deduction depends on the cost of the trellising and the number of days the trellising was owned by the Grower during the income year. It also depends on the extent to which the trellising is installed ready for use during the year.

86. The deduction is calculated using a rate of 13% prime cost or 20% diminishing value. These accelerated rates of depreciation are shown in section 42-125 and apply to plant with an effective life of between 13 and 30 years. The Project Manager will advise Growers of the date that the trellising is installed and begins to be used for the purpose of producing assessable income.

Depreciation deductions for Growers who are not 'small business taxpayers'

87. A Grower who is NOT a 'small business taxpayer' or is a 'small business taxpayer' who does not satisfy the conditions in section 42-345 will not be able to claim accelerated depreciation on plant used in the Project because of section 42-118. The depreciation deduction for trellising for such a Grower is calculated using the formula in either subsection 42-160(3) or subsection 42-165(2A).

88. The deduction depends on the cost of the plant, the number of days the plant was owned by the Grower during the income year and the 'effective life' of the plant (see paragraph 94). It also depends upon the extent to which the plant is installed ready for use during the year. The Project Manager will advise Grower of the date that the trellising is installed and begins to be used for the purpose of producing assessable income.

89. From 1 July 2000, however, the immediate 100% depreciation deduction for plant costing $300 or less has been replaced by a 'low value pool' arrangement for all taxpayers except 'small business taxpayers'.

90. Under subsection 45-455(1), a Grower who is not a 'small business taxpayer' can choose to allocate 'low cost plant' to a 'low value pool' in the year of acquisition. 'Low cost plant' is plant costing less than $1,000. Once the choice is made to allocate 'low cost plant' to the pool, <u>all</u> 'low cost plant' acquired in that income year and subsequent income years must be included in the pool (subsection 42-460(1)).

91. A 'low value pool' is depreciated using a diminishing value rate of 37.5%. However, low cost plant is depreciated at 18.75% in the year it is allocated to the pool, irrespective of the date it is allocated. The value of plant included in or disposed from such a pool will be added to or subtracted from the value of the pool.

92. Under the Lease and Management Agreement, for each interest acquired in the Project a Grower incurs expenditure of $1,210 for trellising and will first be entitled to claim a deduction for depreciation in the year ended 30 June 2002.

93. As the cost of trellising exceeds $1,000 for a Grower who acquires a single interest in the Project, it will not qualify as 'low cost plant. However, provided the Grower uses the diminishing value method to depreciate the trellising, the plant can be allocated to a 'low value pool' after it has been depreciated below $1,000 (paragraph 42-455(3)(b)).

Determination of effective life

94. Subdivision 42-C provides the choice of methods for determining the 'effective life' of plant. Growers can either self-assess the effective life of plant or use the effective life specified by the Commissioner. In the schedule, the Commissioner has determined that the effective life of trellising is 20 years.

Subdivision 387-B – irrigation expenditure

95. Section 387-125 allows a taxpayer, who is carrying on a business of primary production on land in Australia, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a three-year period and applies to plant or a structural improvement primarily or principally used for the purpose of conserving or conveying water for use in a primary production business. Irrigation systems of the kind proposed would be covered by this Subdivision.

96. As the taxpayer who can claim the deduction does not have to actually own the land but can be a tenant, a lessee or licensee who is conducting a primary production business on land in Australia, a deduction would be available to a Grower in the Project at a rate of 33.3 per cent per annum for the cost of the irrigation system.

97. However, a deduction under section 387-125 is denied where the Grower is entitled to claim a water facility tax offset under section 388-55 and chooses to do so. A Grower can only choose a water facility tax offset where:

- had the Grower chosen a deduction instead of the tax offset, the Grower's taxable income for the income year would have been $20,000 or less; and
- the expenditure is incurred before the end of the 2000-01 income year.

Subdivision 387-C - vines and horticultural provisions

98. Section 387-165 allows capital expenditure on establishing horticultural plants owned and used, or held ready for use, in Australia in a business of horticulture to be written off for tax purposes. A lessee or licensee of land carrying on a business of horticulture is taken to own the plants growing on that land rather than the actual owner of the land.

99. Under this Subdivision, if the effective life of the plant is less than three years, the expenditure can be written off in full. If the effective life of the plant is more than three years, an annual deduction is allowable on a prime cost basis during the plant's maximum write-off period. The period starts from the time the plant enters its first commercial season. The write-off rate is detailed in section 387-185. For a plant with an effective life of 13 to 30 years, as in this Project, that rate is 13%.

Division 35 - losses from non-commercial business activities

100. 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.

101. 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.

102. 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.

103. 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.

104. 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).

105. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Grower who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2008. Growers who acquire more than one interest in the Project may, however, pass one of the tests in an earlier income year.

106. 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.

107. 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) until 30 June 2005.

108. 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.

109. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 50), in the manner described in the Arrangement (see paragraphs 14 to 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.

110. 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 figures provided in the draft Prospectus;
- the inspection of similar projects undertaken by the Responsible Entity; and
- 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.

Section 82KL

111. 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

112. 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).

113. The Magpie Ridge Vineyards Project 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 45 to 46 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.

114. 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 fruit. 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.

Section 6-5 - ITAA 1997: assessable income

115. Gross sale proceeds derived from the sale of grape produce from the project will be assessable income of the Growers, under section 6-5 of ITAA 1997.

116. Once harvested, a Grower's grape produce will be trading stock of the Grower. As a consequence, if grapes or grape juice are on hand at the end of the income year, the Grower will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of ITAA 1997.

117. Each Grower will be notified by Magpie Ridge Vineyards 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.

Example

Example 1 – entitlement to 'input tax credit'

118. 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 x $5,500 = $500

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

Detailed contents list

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

	Paragraph
What this Product Ruling is about	**1**
Tax law(s)	2
Goods and Services Tax	3
Business Tax Reform	4
Note to promoters and advisers	6
Class of persons	7
Qualifications	9
Date of effect	**11**
Withdrawal	**13**

Arrangement	**14**
Overview	16
Constitution	23
Interest in land	24
Lease and Management Agreement	25
Fees	29
Planting	39
Harvesting	40
Finance	42
Ruling	**44**
Assessable income	44
Deductions where a Grower is not registered nor required to be registered for GST	45
Tax deductions for capital expenses	46
Deductions where a Grower is registered or required to be registered for GST	47
Sections 82KZM, 82KZMB – 82KZMD, 82KL and Part IVA	48
Prepaid fees	49
Section 35-55 – losses from non-commercial business activities	50
Explanations	**53**
Section 8-1	53
Is the Grower carrying on a business?	54
Sections 82KZM and 82KZMB – 82KZMD	63
Prepaid fees	67
Interest deductibilty	72
Expenditure of a capital nature	75
Section 42-15 – depreciation of trellising	76
Small business taxpayers	82
Depreciation deductions for Growers who are ‘small business taxpayers’	85
Depreciation deductions for Growers who are not ‘small business taxpayers’	87
Determination of effective life	94
Subdivision 387-B – irrigation expenditure	95

Subdivision 387-C – vines and horticultural provisions 98
Division 35 – losses from non-commercial business activities 100
Section 82KL 111
Part IVA – general tax avoidance provisions 112
Section 6-5 – ITAA 1997: assessable income 115
Example **118**
Example 1: entitlement to 'input tax credit' 118
Detailed contents list **119**

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Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 92/20; TR 97/11; TR 97/16; TR 98/22; TD 93/34; IT 175; IT 2001

Subject references:

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

Legislative references:

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- ITAA 1997 8-1
- ITAA 1997 17-5
- ITAA 1997 Div 27
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