PR 2002/32 - Income tax: Mt Benson Premium Estates Vineyard Project

Product Ruling
Income tax: Mt Benson Premium Estates Vineyard Project

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Potential participants 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. 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 participants 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 this product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential participants 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 refers. In this Ruling this arrangement is sometimes referred to as the 'Mt Benson Premium Estates Vineyard Project' 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);
- Division 40 (ITAA 1997);
- Part 2-25 (ITAA 1997);
- Division 328 (ITAA 1997);
- Section 82KL of the Income Tax Assessment Act 1936 ('ITAA 1936');
- Section 82KZL (ITAA 1936);
- Section 82KZME (ITAA 1936);
- Section 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.

Changes in the Law

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 taxation legislation enacted at the time it was issued, later amendments may impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating 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 participants in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is the persons who are more specifically identified in the Ruling part of this Product Ruling and who enter into the arrangement specified 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. 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 arrangement described in the Ruling is materially different from the arrangement that is actually carried out, the Ruling has no binding effect on the Commissioner. The Ruling will be withdrawn or modified.

10. A Product Ruling may only be reproduced in its entirety. Extracts may not be reproduced. As each Product Ruling is copyright,

Date of effect

11. This Ruling applies prospectively from 27 March 2002, 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 that private ruling if the income year to which it relates has ended or has commenced but not yet ended. However if the arrangement covered by the private ruling has not commenced, 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 arrangement specified below. 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 person's involvement in the arrangement.

Arrangement

14. The arrangement that is the subject of this Ruling is specified below. This arrangement incorporates the following documents:

- Application for Product Ruling dated 30 April 2001;
- Draft Prospectus for the Mt Benson Premium Estates Vineyard Project, received 21 February 2002;
- Draft **Constitution** for Mt Benson Premium Estates Vineyard Project, received 19 March 2002;

- Draft **Lease Agreement** between Australian Rural Group Ltd (the 'Licensor') and the Grower (the 'Lessee'), received 19 March 2002;
- Draft **Management Agreement** between ARG Management Ltd (the 'Manager') and the Grower, received 19 March 2002;
- Draft **Contract for the Sale and Purchase of Grapes** ('Grape Sale Agreement') between the Grower and Mt Benson Premium Estates Pty Ltd (the 'Winemaker'), received 13 March 2002; and
- Draft Compliance Plan for the Mt Benson Premium Estates Vineyard Project, received 21 February 2002;
- Draft Lease Agreement between Downrow Pty Ltd (the "Lessor") and Australian Rural Group Ltd (the "Lessee") undated;
- Draft Project Management Agreement between ARG Management Ltd (the 'Responsible Entity') and Mt Benson Premium Estates Pty Ltd (the 'Operational Manager');
- Additional correspondence dated 10 October 2001, 30 May 2001, 10 August 2001, 14 August 2001, 30 October 2001, 12 November 2001, 15 November 2001, 15 February 2002, 21 February 2002, 22 February 2002, 13 March 2002, 16 March 2002 and 19 March 2002.

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 that Growers may enter into. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are a part of the arrangement to which this Ruling applies.

16. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of these agreements is summarised as follows.

Overview

17. The arrangement is called Mt Benson Premium Estates Vineyard Project. The salient features of the arrangement are:

Location	Near Robe on the south east coast of South Australia, approximately 330 kms south east of Adelaide
Type of business each participant is carrying on	Growing and harvesting of grapes for the sale of the fruit
Number of hectares offered	166 hectares
Size of each Interest	0.404 hectares (1 acre)
Minimum Subscription	$400,000 (21 interests)
Number of vines per hectare	Approximately 2,400
Expected production	Ranging between 5 tonnes per hectare in year 3 to 11.1 tonnes per hectare at full production for the year 5 and subsequent harvests
Term of the Project	Approximately 16 years
Initial minimum cost	$20,999
Initial cost per hectare	$51,978
Ongoing costs	Annual lease and management fees Optional insurance costs

18. The Project will be a Management Investment Scheme under the Corporations Act. ARG Management Ltd ('ARGM') will be both the Responsible Entity and Manager of the Project. The Project will be conducted on land at Section 19, Kingston Robe Highway, South Australia, more particularly described in Certificate of Title Volume 5667 Folio 351.

19. Under this offer Growers may enter the Project in either the 2001/02 income year (defined as a '2002 Grower' for the purposes of this Ruling) or the 2002/03 income year ('2003 Grower'). Growers participating in the arrangement will enter into a Lease Agreement and a Management Agreement which are annexed to the Constitution.

20. The Lease Agreement gives a Grower a Lease over an identifiable area of land for a period of approximately 16 years. For the purposes of this Ruling each interest leased to a Grower is called a 'Vinelot'. Each Vinelot is an area of 1 acre (approximately 0.404 hectares) and this offer pertains to a maximum of 166 hectares. Under the Prospectus there is a minimum subscription to be raised of $400,000, equating to 21 Vinelots.

21. The Manager is responsible for the cultivation and maintenance of the Vinelot and the harvesting of grapes produced. The Manager will engage Mt Benson Premium Estates Pty Ltd

('MBPEPL') in its capacity as the 'Operational Manager' to carry out the necessary land preparation and vineyard development as required by the Management Agreement. The Prospectus refers to MBPEPL as the 'Project Manager'. Grapevines will be planted at a rate of approximately 969 per Vinelot. All Grapes will be purchased by MBPEPL for winemaking purposes.

22. Upon application, Growers will execute a Power of Attorney enabling the Responsible Entity to act on their behalf as required.

Constitution

23. The Constitution establishes the Project and operates as a deed binding on the Responsible Entity and all of the Members (Growers). The Constitution sets out the terms and conditions under which ARG Management Ltd agrees to act as Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 17.1 of the Constitution, the Responsible Entity will keep a register of Growers.

24. Under the terms of the Constitution, all moneys received from applications shall be paid to ARGM as the Responsible Entity, which shall deposit those moneys into the Applications Bank Account (clause 15.2). The Responsible Entity will forward a Notice of Acceptance upon acceptance of each Grower's application and the application monies will be released to the Scheme Bank Account. (clauses 15.5 and 15.8).

Compliance Plan

25. As required by the Corporations Law, a Compliance Plan has been prepared by ARG Management Ltd. Its purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Lease Agreement

26. Growers are granted an interest in land in the form of a lease. The Lease Agreement gives Growers a right to use their Vinelot for the purpose of conducting their viticultural business. The lease is granted by Australian Rural Group Ltd (ARG) to Growers under the terms of the Lease Agreement for a term ending on the completion of the harvest in the year which is 16 years from the date the agreement is executed.

27. Each Grower must pay a rental fee to ARG of an amount specified in Item 5 of the Schedule to the Lease Agreement.

28. The conditions of the lease are outlined in clause 3 of the Agreement. Some of the conditions of the lease are that the Grower must, amongst other things:

- ensure that at all times the cultivation, maintenance and management of the Land is carried out in accordance with best practices of the viticultural industry; and
- observe and comply with all regulations, notices, orders and directions given by any statutory or public authority, Municipal or Shire Council or any other authority relating to the use of the Land and must carry out the requirements thereof at its own expense.

Management Agreement

29. Each Grower enters into a Management Agreement with ARGM as the Manager. The Management Agreement sets out the terms and conditions under which ARGM agrees to act as the Manager. The Manager will establish a vineyard on the Grower's Vinelot and manage and maintain the vineyard.

30. The Agreement commences on the date the Management Agreement is executed by the Manager and will continue until the expiration of the Grower's lease.

31. The Manager must develop the Vinelots and manage the Vineyard. To carry out its obligations the Manager will engage MBPEPL to develop, establish and maintain the vineyard under the supervision of and pursuant to instructions from the Manager. Amongst other things the Manager must:

- supply and plant on the Land healthy vine rootlings;
- supply and install irrigation equipment and vineguards;
- undertake the general maintenance of the vineyard including controlling weeds, vermin or other pests which may impede the growth of the vines;
- apply fertiliser to the Land in such form and in such quantities necessary to maintain satisfactory growth;
- maintain and repair all fire breaks and access roads in and about the Land; and
- provide advice and assistance to the Grower in accordance with the best practices of the Viticultural industry.

Fees

32. Fees are payable by the Grower on application. Under the Lease and Management Agreements a total of $20,999 per Vinelot is payable for services to be provided during the Initial Period, being the 12 month period following the Settlement Date, the date of acceptance of the Grower's application. This initial fee comprises:

- $10,693 for management services,
- $3,300 for the cost of supply and planting rootlings;
- $4,177 for the supply and installation of irrigation equipment;
- $2,279 for the supply and installation of trellising; and
- a Lease fee (Rent) of $550.

33. Following the Initial Period, Annual Management Fees will be payable for vineyard maintenance. These will be payable in advance, on each anniversary of the Settlement Date. For the 12 months following the Initial Period the fee is $4,136. Thereafter the fee will be set at $2,500 indexed at the greater of 3% per annum or the annual rate of inflation.

34. Following the Initial Period, Lease Fees will be payable for each successive 12 month period in advance on the anniversary of the Settlement Date. For the 12 months following the Initial Period the fee is $567. Thereafter the amount will be set at the amount of the fee in the prior year indexed at the greater of 3% per annum or the annual rate of inflation.

35. If any portion of the vines are destroyed for any reason whatsoever after the second year from planting of the vines, then following a report by an independent expert, the Management Fees and Lease fees will be proportionately reduced.

36. If so requested by the Grower, the Manager will arrange insurance of the Grower's leased area against destruction or damage by fire.

Planting

37. During the Initial Period the Manager will be responsible for planting healthy vine rootlings to an average density of 2,400 vines per hectare. The Management Agreement specifies 600 vines per 0.25 hectares. The Manager will manage the vines in accordance with good viticultural practice. Any vines which die during the first year after planting, where such death is caused by planting techniques or vermin control, will be replanted by the Manager.

Harvesting and Sale

38. The Manager will harvest the grapes produced on the Grower's Vinelots from the date of the first commercially harvestable crop from the vineyard. The Grower will appoint the Manager to market and sell the harvested grapes (clause 7(a) of the Management Agreement). Growers will share the proceeds from sale on a proportionate basis following harvesting costs.

39. ARGM will enter into a contract with the Project's Operational Manager, MBPEPL, in its capacity as the Winemaker, for the sale and purchase of grapes (the 'Grape Sale Agreement'). ARGM will act as agent on behalf of all of the Growers. The Winemaker has agreed to purchase the grapes grown on the vineyard for the term of the Project upon terms set out in the Grape Sale Agreement. The price will be set for an initial 8 year term at an amount equal to the greater of market value or $1,750 per tonne.

40. The proceeds from the sale of grapes will be paid direct to ARGM who must deposit them into the Scheme Bank Account (clause 18.1 of the Constitution). Each Grower will have a share in the sales proceeds which will be distributed among the Growers according to their proportional interest in the Project (clause 7(c) of the Management Agreement).

Finance

41. Growers can fund their participation in the Project themselves or borrow from an independent lender.

42. 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; or
- entities associated with the Project are involved, or become involved, in the provision of finance for the Project.

Ruling

Application of this Ruling

43. This Ruling applies only to Growers who are accepted to participate in the Project:

- on or before 30 June 2002, where the Grower has executed Lease and Management Agreements on or before that date ('2002 Growers'); and/or
- on or after 1 July 2002 and before the expiry of the Prospectus where the Grower has executed Lease and Management Agreements on or between those dates ('2003 Growers').

44. The Grower's participation in the Project must constitute the carrying on of a business of primary production.

Minimum subscription

45. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the Project is accepted and the Project has commenced. Under the terms of the Prospectus a Grower's application will not be accepted and the Project will not proceed until the minimum subscription of $400,000 is achieved.

The Simplified Tax System ('STS')

Division 328

46. For a Grower participating in this Project the recognition of income and the timing of tax deductions is different depending on whether the Grower is an 'STS taxpayer'. To be an 'STS taxpayer' a Grower:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

Qualification

47. This Product Ruling assumes that a Grower who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Grower may become an 'STS taxpayer' at a later point in time. Also, a Grower who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer' during the term of the Project. These are contingencies, relating to the circumstances of individual Growers that cannot be accommodated in this Ruling. Such Growers can ask for a private ruling on how the taxation legislation applies to them.

Prepaid fees

48. Lease and Management fees incurred by Growers who are accepted into this Project are subject to the prepayment rules in sections 82KZME and 82KZMF. In this context, a prepayment refers to advance expenditure incurred by a Grower in return for the doing of a thing that will not be wholly done in the year in which the expenditure is incurred. Where a Grower prepays expenditure that would otherwise be a general deduction under section 8-1 of the ITAA 1997 in the expenditure year, the Grower must apportion the prepayment over the period the prepayment covers unless it is 'excluded expenditure' (see Note (iv) below).

49. Subsection 82KZMF(1) provides the formula for determining how much of the prepaid expenditure a Grower can deduct for each income year. In that formula, which is shown below, the 'eligible service period' 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.

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

50. In this Project, the tax deductions allowable for Management fees and Lease fees must be calculated by applying the above formula to the amount incurred each year by the Grower.

Tax outcomes for Growers who are not 'STS taxpayers'

Assessable Income

Section 6-5

51. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

52. The Grower recognises ordinary income from carrying on the business of viticulture at the time that income is derived.

Trading stock

Section 70-35

53. A Grower who is not an 'STS taxpayer' may, in some years, hold grapes that will constitute trading stock on hand. Where, in an income year, the value of trading stock on hand at the *end* of an income year exceeds the value of trading stock on hand at the *start* of an income year a Grower must include the amount of that excess in assessable income.

54. Alternatively, where the value of trading stock on hand at the *start* of an income year exceeds the value of trading stock on hand at the *end* of an income year, a Grower may claim the amount of that excess as an allowable deduction.

Deductions for Management fees and Lease fees

Section 8-1

55. A Grower who is not an 'STS taxpayer' may claim tax deductions for revenue expenses as detailed in the following tables.

2002 Growers

Fee Type	ITAA 1997 Section	Year ending 30/6/2002	Year ending 30/6/2003	Year ending 30/6/2004
Management Fee	8-1	Amount must be calculated – See Notes (i) & (ii) below	Amount must be calculated – See Notes (i) & (ii) below	Amount must be calculated – See Notes (i), (ii) & (iii) below
Lease Fee (Rent)	8-1	Amount must be calculated – See Notes (i) & (iv) below	Amount must be calculated – See Notes (i) & (iv) below	Amount must be calculated – See Notes (i), (iii) & (iv) below

2003 Growers

Fee Type	ITAA 1997 Section	Year ending 30/6/2003	Year ending 30/6/2004
Management Fee	8-1	Amount must be calculated – See Notes (i) & (ii) below	Amount must be calculated – See Notes (i) & (ii) below
Lease Fee (Rent)	8-1	Amount must be calculated – See Notes (i) & (iv) below	Amount must be calculated – See Notes (i) & (iv) below

Notes:

(i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See Example 1 at paragraph 119;

(ii) The Management fees shown in paragraph 32 and 33 above are **NOT** deductible in full in the year incurred. The deduction for each year's fees must be determined using the formula in subsection 82KZMF(1) (see paragraph 49). The Project Manager will inform Growers of the number of days in the 'eligible service period' in the first expenditure year. This figure is necessary to calculate the deduction allowable for the fees incurred. (See Example 2 at paragraph 120);

(iii) If any portion of the vines are destroyed for any reason whatsoever after the second year from planting, then following a report by an independent expert the management fees and Lease fees will be proportionately reduced;

(iv) Although the Lease Agreement requires the Lease fee to be prepaid, for a Grower who acquires the minimum allocation, the amount of the prepaid Lease fee is less than $1,000. For the purposes of this Project, an amount of less than $1,000 is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and, for a Grower who is not an 'STS taxpayer', is deductible in full in the year in which it is incurred (see Example 3 at paragraph 121). However, where a Grower acquires more than the minimum allocation in the Project, the amount of the Grower's prepaid Lease fee may be $1,000 or more. Such Growers **MUST** determine the deduction for the prepaid Lease fee on the same basis as the prepaid Management fees, i.e., using the formula shown above in paragraph 49.

Deductions for capital expenditure

Division 40

56. A Grower who is not an 'STS taxpayer' will also be entitled to tax deductions relating to trellising, water facilities (e.g., irrigation) and grapevines. All deductions shown in the following Tables are determined under Division 40.

2002 Growers

Fee type	ITAA 1997 section	Year ending 30/6/2002	Year ending 30/6/2003	Year ending 30/6/2004
Trellising	40-25	Must be calculated – See Notes (v) & (vi) below	Must be calculated – See Notes (v) & (vi) below	Must be calculated – See Notes (v) & (vi) below
Water facilities (Irrigation)	40-515	$1,393 See Notes (v) & (viii) below	$1,392 See Notes (v) & (viii) below	$1,392 See Notes (v) & (viii) below
Establishment of horticultural plants	40-515	Nil – See Note (ix) below	Nil – See Note (ix) below	Nil – See Note (ix) below

2003 Growers

Fee type	ITAA 1997 section	Year ending 30/6/2003	Year ending 30/6/2004
Trellising	40-25	Must be calculated – See Notes (v) & (vi) below	Must be calculated – See Notes (v) & (vi) below
Water facilities (Irrigation)	40-515	$1,393 See Notes (v) & (viii) below	$1,392 See Notes (v) & (viii) below
Establishment of horticultural plants	40-515	Nil – See Note (ix) below	Nil – See Note (ix) below

Notes:

(v) If the Grower is registered or required to be registered for GST, amounts of capital expenditure would need to be adjusted as relevant for GST (e.g., input tax credits). See Example 1 at paragraph 119;

(vi) Trellising is a 'depreciating asset'. Each Grower's interest in the trellising is a 'depreciating asset'. The 'cost' of the asset is the amount paid by each Grower. The decline in value of the asset is calculated using the formula in either subsection 40-70(1) ('diminishing value method') or subsection 40-75(1) ('prime cost method'). Both formulae rely on the 'effective life' of the trellising;

(vii) Growers can either self-assess the 'effective life' (section 40-105) or use the Commissioner's determination of 'effective life' (section 40-100). The Commissioner has determined that trellising has an 'effective life' of 20 years. Trellising will be installed and first used either during the year ended 30 June 2002 or 30 June 2003 for 2002 Growers, and either 30 June 2003 or 30 June 2004 for 2003 Growers. The Project Manager will advise Growers when that occurs to enable Growers to calculate the deduction for the decline in value;

(viii) Any irrigation system, dam or bore is a 'water facility' as defined in subsection 40-520(1), being used primarily and principally for the purpose of conserving or conveying water. A deduction is available under Subdivision 40-F, paragraph 40-515(1)(a). This deduction is equal to one third of the capital expenditure incurred by each Grower on the installation of the 'water facility' in the year in which it is incurred and one third in each of the next 2 years of income (section 40-540);

(ix) As grapevines are affixed to land which the Grower does not own, they are not owned by the Grower, the conditions in subsection 40-525(3) cannot be met, and the grapevines are not eligible for the 4 year write-off under section 40-550. However, grapevines are a 'horticultural plant' as defined in subsection 40-525(2). As Growers hold the land under a Lease, one of the conditions in subsection 40-525(2) is met and a deduction for 'horticultural plants' is available under paragraph 40-515(1)(b) for their decline in value. The deduction for the grapevines is determined using the formula in section 40-545 and is based on the capital expenditure incurred by the Grower that is attributable to their establishment. If the grapevines have an 'effective life' of greater than 13 but fewer than 30 years for the purposes of section 40-545, this results in a straight-line write-off at a rate of 13%. The deduction is allowable when the grapevines enter their first commercial season (section 40-530, item 2). The Project Manager will inform Growers when the grapevines enter their first commercial season.

Tax outcomes for Growers who are 'STS taxpayers'

Assessable Income

Section 6-5

57. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

58. The Grower recognises ordinary income from carrying on the business of viticulture at the time the income is received (paragraph 328-105(1)(a)).

Treatment of trading stock

59. A Grower who is an 'STS taxpayer' may, in some years, hold grapes that will constitute trading stock on hand. Where the difference between the value of all such a Grower's trading stock at the start of an income year and a reasonable estimate of it at the end of that year, is less than $5,000, the Grower does not have to account for that difference under the ordinary trading stock rules in Division 70 (subsection 328-285(1)).

Deductions for Management fees and Lease fees

Section 8-1 and section 328-105

60. A Grower who is an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

2002 Growers

Fee Type	ITAA 1997 Sections	Year ending 30/6/2002	Year ending 30/6/2003	Year ending 30/6/2004
Management Fee	8-1 & 328-105	Must be calculated – See Notes (x) & (xi) below	Must be calculated – See Notes (x) & (xi) below	Must be calculated – See Notes (x), (xi) & (xii) below
Lease Fee (Rent)	8-1 & 328-105	Must be calculated – See Notes (x) &(xiii) below	Must be calculated – See Notes (x) & (xiii) below	Must be calculated – See Notes (x), (xii) & (xiii) below

2003 Growers

Fee Type	ITAA 1997 Sections	Year ending 30/6/2003	Year ending 30/6/2004
Management Fee	8-1 & 328-105	Must be calculated – See Notes (x) & (xi) below	Must be calculated – See Notes (x) & (xi) below
Lease Fee (Rent)	8-1 & 328-105	Must be calculated – See Notes (x) &(xiii) below	Must be calculated – See Notes (x) &(xiii) below

Notes:

(x) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits). See Example 1 at paragraph 119;

(xi) The Management fees shown in paragraph 32 and 33 above are **NOT** deductible in full in the year in which they are paid by, or on behalf of the STS taxpayer. The deduction for each year's fees must be determined using the formula in subsection 82KZMF(1) (see paragraph 49). The Project Manager will inform Growers of the number of days in the 'eligible service period' in the first expenditure year. This figure is necessary to calculate the deduction allowable for the fees incurred. (See Example 2 at paragraph 120);

(xii) If any portion of the vines are destroyed for any reason whatsoever after the second year from planting, then following a report by an independent expert the management fees and Lease fees will be proportionately reduced;

(xiii) Although the Lease Agreement requires the Lease fee to be prepaid, for a Grower who acquires the minimum allocation, the amount of the prepaid Lease fee is less than $1,000. For the purposes of this Project, amounts of less than $1,000 are 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and it is therefore deductible in full in the year in which it is paid (see Example 3 at paragraph 121). However, where a Grower acquires more than the minimum allocation in the Project, the amount of the Grower's prepaid Lease fee may be $1,000 or more. Such Growers **MUST** determine the deduction for the prepaid Lease fee on the same basis as the prepaid Management fees, i.e., using the formula shown above in paragraph 49.

Deductions for capital expenditure

Subdivision 328-D and Subdivisions 40-F and 40-G

61. A Grower who is an 'STS taxpayer' will also be entitled to tax deductions relating to trellising, water facilities (e.g., irrigation) and grapevines. Deductions relating to the 'cost' of trellising must be determined under Division 328. An 'STS taxpayer' may claim deductions in relation to water facilities under Subdivision 40-F. If the 'water facility' expenditure is on a 'depreciating asset' used to carry on the business, they may choose to claim deductions under Division 328. Deductions for the grapevines must be determined under Subdivision 40-F.

62. The deductions shown in the following Tables assume, for representative purposes only, that a Grower has either chosen to or can only claim deductions for expenditure on water facilities under Subdivisions 40-F and not under Division 328. If the expenditure has been incurred on 'depreciating assets' and is claimed under Division 328, the deduction is determined as discussed in Note (xvi) below.

63. Under Division 328, if the 'cost' of a 'depreciating asset' at the end of the income year is less than $1000 (a 'low-cost asset'), it can be claimed as an immediate deduction when first used or 'installed ready for use'. This is so provided the Grower is an 'STS taxpayer' for the income year in which it starts to 'hold' the asset and the income year in which it first uses the asset or has it 'installed ready for use' to produce assessable income.

2002 Growers

Fee type	ITAA 1997 section	Year ending 30/6/2002	Year ending 30/6/2003	Year ending 30/6/2004
Trellising	328-185 & 328-190	Must be calculated – See Notes (xiv) & (xv) below	Must be calculated – See Notes (xiv) & (xv) below	Must be calculated – See Notes (xiv) & (xv) below
Water facilities (Irrigation)	40-515	$1,393 – See Notes (xiv) & (xvi) below	$1,392 – See Notes (xiv) & (xvi) below	$1,392 – See Notes (xiv) & (xvi) below
Establishment of horticultural plants	40-515	Nil – See Note (xvii) below	Nil – See Note (xvii) below	Nil – See Note (xvii) below

2003 Growers

Fee type	ITAA 1997 section	Year ending 30/6/2003	Year ending 30/6/2004
Trellising	328-185 & 328-190	Must be calculated – See Notes (xiv) & (xv) below	Must be calculated – See Notes (xiv) & (xv) below
Water facilities (Irrigation)	40-515	$1,393 – See Notes (xiv) & (xvi) below	$1,392 – See Notes (xiv) & (xvi) below
Establishment of horticultural plants	40-515	Nil – See Note (xvii) below	Nil – See Note (xvii) below

Notes:

(xiv) If the Grower is registered or required to be registered for GST, amounts of capital expenditure would need to be adjusted as relevant for GST (e.g., input tax credits). See Example 1 at paragraph 119;

(xv) Trellising is a 'depreciating asset'. Each Grower's interest in the trellising is a 'depreciating asset' which can be allocated to a 'general STS pool'. The 'cost' of the asset is the amount paid by each Grower. The tax deduction allowable is determined in the year ended 30 June 2002 or year ended 30 June 2003 for 2002

Growers, and in the year ended 30 June 2003 or year ended 30 June 2004 for 2003 Growers by multiplying the 'cost' of the interest by half the 'general STS pool rate', i.e., by 15%. Each Grower's interest in the trellising is allocated to his/her 'general STS pool' at the end of the year ended 30 June 2002 or 30 June 2003 for 2002 Growers, and the end of the year ended 30 June 2003 or 30 June 2004 for 2003 Growers, and that part of the 'cost' not deducted in the first year is added to the pool balance. In subsequent years, the full pool rate of 30% will apply;

(xvi) Any irrigation system, dam or bore is a 'water facility' as defined in subsection 40-520(1), being used primarily and principally for the purpose of conserving or conveying water. If the expenditure is on a 'depreciating asset' (the underlying asset), the Grower may choose to claim a deduction under either Division 328 or Subdivision 40-F. For the purposes of Division 328, each Grower's interest in the underlying asset is itself deemed to be a 'depreciating asset'. If the 'cost' apportionable to that deemed 'depreciating asset' is less than $1000, the deemed asset is treated as a 'low-cost asset' and that amount is deductible in full when the underlying asset is first used or 'held' ready for use. This is so provided the Grower is an 'STS taxpayer' for the income year in which it starts to 'hold' the asset and the income year in which it first uses the asset or has it 'installed ready for use' to produce assessable income. If the deemed asset is not treated as a 'low-cost asset', the tax deduction allowable in either the year ended 30 June 2002 or the year ended 30 June 2003 for 2002 Growers, and in either the year ended 30 June 2003 or the year ended 30 June 2004 for 2003 Growers, is determined by multiplying its 'cost' by half the relevant STS pool rate. At the end of the year, it is allocated to the relevant STS pool and in subsequent years the full pool rate will apply. If the expenditure is not on a 'depreciating asset', or if they choose to use Subdivision 40-F, Growers must claim deductions under Subdivision 40-F, paragraph 40-515(1)(a). This deduction is equal to one third of the capital expenditure incurred by each Grower on the installation of the 'water facility' in the year in which it is incurred and one third in each of the next 2 years of income (section 40-540);

(xvii) As grapevines are affixed to land which the Grower does not own, they are not owned by the Grower, the conditions in subsection 40-525(3) cannot be met, and the grapevines are not eligible for the 4 year write-off under section 40-550. However, grapevines are a 'horticultural plant' as defined in subsection 40-525(2). As Growers hold the land lease, one of the conditions in subsection 40-525(2) is met and a deduction for 'horticultural plants' is available under paragraph 40-515(1)(b) for their decline in value. The deduction for the grapevines is determined using the formula in section 40-545 and is based on the capital expenditure incurred by the Grower that is attributable to their establishment. If the grapevines have an 'effective life' of greater than 13 but fewer than 30 years for the purposes of section 40-545, this results in a straight-line write-off at a rate of 13%. The deduction is allowable when the grapevines enter their first commercial season (section 40-530(2)). The Project Manager will inform Growers when the grapevines enter their first commercial season.

Tax outcomes that apply to all Growers

Interest

64. The deductibility or otherwise 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. However all Growers who borrow funds in order to participate in the Project, should read the discussion of the prepayment rules in paragraphs 87 to 98 (below) as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Growers choice.

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

Section 35-55 – Commissioner's discretion

65. For a Grower who is an individual and who enters the Project during the years ended 30 June 2002 or 30 June 2003, 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 2006 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.

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

- the 'exception' in subsection 35-10(4) applies; or
- a Grower's business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the Grower's business activity produces assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)); or
- the Commissioner is precluded from exercising the discretion under paragraph 35-55(1)(b) because of subsection 35-55(2).

67. Where the 'exception' in subsection 35-10(4) applies, or the Grower's business activity satisfies one of the tests, or the discretion in subsection 35-55(1) is exercised, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of the 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.

68. 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 commercially viable. An assessment of the Project or the product from this perspective has not been made.

Sections 82KL and Part IVA

69. 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:

- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Explanations

Is the Grower carrying on a business?

70. For the amounts set out in the Tables above to constitute allowable deductions the Grower's viticulture activities as a participant in the Mt Benson Premium Estates Vineyard Project must amount to the carrying on of a business of primary production. These viticulture activities will fall within the definitions of 'horticulture' and 'commercial horticulture' in section 40-535 of the ITAA 1997.

71. For schemes such as that of the Mt Benson Premium Estates Vineyard Project, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of such a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *FCT v. Lau* 84 ATC 4929.

72. Generally, a Grower will be carrying on a business of viticulture, and hence primary production, if:

- the Grower has an identifiable interest (by lease or by Lease) in the land on which the Grower's grapevines are established;
- the Grower has a right to harvest and sell the grapes each year from those grapevines;
- the viticulture activities are carried out on the Grower's behalf;
- the viticulture activities of the Grower are typical of those associated with a viticulture business; and
- the weight and influence of general indicators point to the carrying on of a business.

73. In this Project, each Grower enters into a Management Agreement with ARG Management Ltd and a Lease Agreement with Australian Rural Group Ltd.

74. Under the Lease Agreement each individual Grower will have rights over a specific and identifiable area of land. The Lease Agreement provides the Grower with an ongoing interest in the specific grapevines on the leased area for the term of the Project. Under the Lease the Grower must use the land in question for the purpose of carrying out viticultural activities and for no other purpose. The Lease allows the Manager to come onto the land to carry out its obligations under the Management Agreement.

75. Under the Management Agreement the Manager is engaged by the Grower to establish and maintain a Vinelot on the Grower's identifiable area land during the term of the Project. The Manager has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the allotment on the Grower's behalf.

76. In establishing the Vinelot, the Grower engages the Manager to purchase and install trellising and water facilities (e.g., irrigation) and to acquire and plant vine seedlings/rootlings on the Grower's Vinelot. During the term of the Project, these assets will be used wholly to carry out the Grower's viticulture activities. The Manager is also engaged to harvest and sell, on the Grower's behalf, the grapes grown on the Grower's Vinelot.

77. 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.

78. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Grower in the project will derive assessable income from the sale of its grapes that will return a 'before-tax' profit, i.e., a 'profit' in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

79. The pooling of grapes grown on the Grower's allotment with the grapes of other Growers is consistent with general viticulture practices. Each Grower's proportionate share of the sale proceeds of the pooled grapes will reflect the proportion of the grapes contributed from their Vinelot(s).

80. The Manager's services and the installation of assets on the Grower's behalf are also consistent with general viticulture practices. The assets are of the type ordinarily used in carrying on a business of viticulture. While the size of a single Vinelot is relatively small, it is of a size and scale to allow it to be commercially viable (see Taxation Ruling IT 360).

81. The Grower's degree of control over the Manager as evidenced by the Management Agreement, and supplemented by the Corporations Act, is sufficient. During the term of the Project, the Manager will provide the Grower with regular progress reports on the Grower's allotment and the activities carried out on the Grower's behalf. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect.

82. 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. For the purposes of this Ruling, the Growers' viticulture activities in the

Mt Benson Premium Vineyard Estates Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

83. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

84. The question of whether a Grower is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of management fees and Lease fees

Section 8-1

85. Consideration of whether the initial management fees and 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 is contractually committed 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.

86. The Lease fees and management fees associated with the viticulture activities will relate to the gaining of income from the Grower's business of viticulture (see above), 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.

Prepayments provisions

Sections 82KZL to 82KZMF

87. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (eg. the performance of management services or the leasing of land) that will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

88. 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). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes 'STS taxpayers' from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

89. Where the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see paragraph 93 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)).

90. 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.

91. 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, in order to participate in the Project may borrow funds from a financier. 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.

92. 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.

93. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion 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.

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

94. 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

95. The expenditure incurred by a Grower in the Project for the management fees and Lease fees meets the requirements of subsections 82KZME(1) and (2) and is incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies, the amount and timing of tax deductions for those fees are determined under section 82KZMF.

96. The prepaid management fees incurred by Growers do not fall within any of the 5 exceptions to section 82KZME. Therefore, the deduction for each year is determined using the formula in subsection 82KZMF(1). Section 82KZMF will apportion the deduction for prepaid Management fees over the period that the services for which the prepayment is made are provided.

97. The prepaid lease fees, being amounts of less than $1,000 in each expenditure year, constitute 'excluded expenditure' as defined in subsection 82KZL(1). Under Exception 3 (subsection 82KZME(7)) 'excluded expenditure' is specifically excluded from the operation of section 82KZMF. A Grower who is an 'STS taxpayer' can, therefore, claim an immediate deduction for a lease fee in the income year in which it is paid. A Grower who is not an 'STS taxpayer' can claim an immediate deduction for a lease fee in the income year in which it is incurred.

98. However, where a Grower acquires more than the minimum allocation of one interest in the Project and the quantum of the prepaid lease fees is $1,000 or more, the deduction allowable for those amounts will also be subject to apportionment according to the formula in subsection 82KZMF(1).

Interest deductibility

Section 8-1

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

100. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements <u>may</u> require interest to be prepaid. Alternatively, a Grower may <u>choose</u> 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 87 to 98).

Expenditure of a capital nature

Division 40 and Division 328

101. Any part of the expenditure of a Grower 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, expenditure attributable to trellising, water facilities and the establishment of grapevines is of a capital nature. This expenditure falls for consideration under Division 40 or Division 328 of the ITAA 1997.

102. The application and extent to which a Grower claims deductions under Division 40 and Division 328 depends on whether or not the Grower is an 'STS taxpayer'.

103. The tax treatment of capital expenditure has been dealt with in a representative way in paragraphs 56 and 61 to 63 (above) in the Tables and the accompanying Notes.

Division 35 - deferral of losses from non-commercial business activities

104. Division 35 applies to losses from certain business activities for the income year ended 30 June 2001 and subsequent years. Under the rule in subsection 35-10(2), a deduction for a loss made by an individual (including an individual in a general law partnership) from certain business activities will not be taken into account in an income year unless:

- the 'exception' in subsection 35-10(4) applies;
- one of four tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

105. 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.

106. Losses that cannot be taken into account in a particular year of income, because of subsection 35-10(2), can be applied to the extent of future profits from the business activity, or are deferred until one of the tests is passed, the discretion is exercised, or the exception applies.

107. For the purposes of applying the 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.

108. In broad terms, the 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 (excluding cars, motor cycles and similar vehicles) are used on a continuing basis in carrying on the business activity in that year (section 35-45).

109. 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 allocation in the Project of one interest is unlikely to pass one of the tests until the year ended 30 June 2009. Growers who acquire more than one interest in the Project may however, find that their activity meets one of the tests in an earlier income year.

110. 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.

111. 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, 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) because of its nature, it has not yet met one of the tests set out in Division 35; and

(iii) there is an expectation that the business activity of an individual taxpayer will either pass one of the tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

112. Information provided with this Product Ruling indicates that a Grower who acquires the minimum allocation in the Project is expected to be carrying on a business activity that will either pass one of the tests, or produce a taxation profit, for the year ended 30 June 2007. The Commissioner will decide for such a Grower that it would be reasonable to exercise the second arm of the discretion until the year ended 30 June 2006. Subsection 35-55(2) prevents the Commissioner exercising the discretion beyond this year.

113. 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 65) in the manner described in the Arrangement (see paragraphs 14 to 42). If so, this Ruling, and specifically the decision in relation to paragraph 35-55(1)(b), that it would be unreasonable that the loss deferral rule in subsection 35-10(2) not apply, may be affected, because the Ruling no longer applies (see paragraph 9). 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.

114. In deciding that the second arm of the discretion in paragraph 35-55(1)(b) will be exercised on this conditional basis, the Commissioner has relied upon:

- the report of the Independent Viticulturist and additional evidence provided with the application by the Manager;
- the draft Grape Sale Agreement; 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, submitted in the Product Ruling application.

Section 82KL – recouped expenditure

115. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(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

116. 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).

117. The Mt Benson Premium Estates Vineyard Project will be a 'scheme' commencing with the issue of the Prospectus. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 55 to 63 that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

118. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual 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 are 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 GST input tax credits

119. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001 Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2002 to 30/6/2002	$4,400*
Carrying out of upgrade of power for your vineyard as quoted	$2,200*
Total due and payable by 1 January 2002 (includes GST of $600)	$6,600

*Taxable supply

Susan pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

$$^{1}/_{11} \text{ x } \$4,400 = \$400.$$

Hence her outgoing for the management fee is effectively $4,400 *less* $400, or $4,000.

Similarly, Susan calculates her input tax credit on the connection of electricity as:

$$^{1}/_{11} \text{ x } \$2,200 = \$200.$$

Hence her outgoing for the power upgrade is effectively $2,200 *less* $200, or $2,000.

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as $4,000 (not $4,400).

Susan is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as $200 (one tenth of $2,000 only, not one tenth of $2,200).

Example 2 – Prepaid expenditure and the apportionment of fees

120. Ray decides to participate in the ABC Pineforest Prospectus which is offering 500 interests of 0.5ha in an afforestation project of 25 years. The management fees are $5,000 in the first year and $1,200 for years 2 and 3. From year 4 onwards the management fee will be the previous year's fee increased by the CPI. The first year's fees are payable on execution of the agreements for services to be provided in the following 12 months and thereafter, the fees are payable in advance each year on the anniversary of that date. The project is subject to a minimum subscription of 300 interests. Ray provides the Project Manager with a 'Power of Attorney' allowing the Manager to execute his Management Agreement and the other relevant agreements on his behalf. On 5 June 2002 the Project Manager informs Ray that the minimum subscription has been reached and the Project will go ahead. Ray's agreements are duly executed and management services start to be provided on that date.

Ray is an 'STS taxpayer' who is not registered nor required to be registered for GST. He calculates his tax deduction for management fees for the **2002 income year** as follows:

$$\text{Management fee x } \frac{\text{Number of days of eligible service period in the year of income}}{\text{Total number of days of eligible service period}}$$

$$\$5,000 \text{ x } ^{26}/_{365}$$

= **$356** (this is Ray's total tax deduction in 2002 for the Year 1 prepaid management fees of $5,000. It represents the 26 days for which management services were provided in the 2002 income year).

In the **2003 income year** Ray will be able to claim a tax deduction for management fees calculated as the sum of two separate amounts:

$5,000 x $^{339}/_{365}$

= **$4,643** (this represents the balance of the Year 1 prepaid fees for services provided to Ray in the 2003 income year).

$1,200 x $^{26}/_{365}$

= **$85** (this represents the portion of the Year 2 prepaid management fees for the 26 days during which services were provided to Ray in the 2003 income year).

$4,643 + $85 = $4,728 (The sum of these two amounts is Ray's total tax deduction for management fees in 2003).

Ray continues to calculate his tax deduction for prepaid management fees using this method for the term of the Project.

Example 3 – Apportionment of fees where there is a contractual 'eligible service period' and the fees include expenditure that is 'excluded expenditure'

121. On 1 June 2002 Kevin applies for an interest into the Western Bluegum Project, a prospectus based afforestation project of 12 years. Kevin is accepted into the project and executes a lease and management agreement with the Manager for the provision of management services and the lease of his Woodlot. The terms of the lease and management agreement require Kevin to prepay the management fees and the lease fee on or before the 30 June each year for the lease of his Woodlot and the provision of management services between the 1 July and 30 June in the following income year. Kevin pays the first year management fee of $3,600 and first year lease fee of $500 on 15 June 2002.

Kevin, who is not an 'STS taxpayer', is not registered nor required to be registered for GST. He calculates his tax deduction for management fees and the lease fee for the **2002 income year** as follows:

Management fee

Even though he paid the $3,600 in the 2002 income year, because there are no 'days of eligible service period' in that year, Kevin is unable to claim any part of his management fees as a tax deduction in his tax return for the year ended 30 June 2002.

Lease fee

Because the $500 lease fee is less than $1,000 it is ‘excluded expenditure’ and can be claimed in full as a tax deduction in Kevin’s tax return for the year ended 30 June 2002.

In the **2003 income year** Kevin can claim a tax deduction for his first year’s management fees calculated as follows:

$3,600 x $^{365}/_{365}$

= **$3,600** (this represents the whole of the first year’s management fee prepaid in the 2002 income year but not deductible until the 2003 income year).

For the term of the Project Kevin continues to calculate his tax deduction for prepaid fees using this method.

Detailed contents list

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

Commissioner of Taxation
27 March 2002

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
PR 1999/95; TR 92/1; TR 92/20; TR 97/11; TR 97/16; TD 93/34; TR 92/20; TR 98/22; TR 2000/8; TR 2001/14

Subject references:
- carrying on a business
- commencement of business
- primary production

- primary production expenses
- management fee expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:
- TAA 1953 Pt IVAAA
- ITAA 1997 Pt 2-25
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
- ITAA 1997 17-5
- ITAA 1997 Div 27
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-30
- ITAA 1997 35-35
- ITAA 1997 35-40
- ITAA 1997 35-45
- ITAA 1997 35-55
- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
- ITAA 1997 35-55(2)
- ITAA 1997 Div 40
- ITAA 1997 40-25
- ITAA 1997 40-70(1)
- ITAA 1997 40-75(1)
- ITAA 1997 Subdiv 40-F
- ITAA 1997 Subdiv 40-G
- ITAA 1997 40-100
- ITAA 1997 40-105
- ITAA 1997 40-515
- ITAA 1997 40-515(1)(a)
- ITAA 1997 40-515(1)(b)
- ITAA 1997 40-520(1)
- ITAA 1997 40-525(2)
- ITAA 1997 40-525(3)
- ITAA 1997 40-530
- ITAA 1997 40-530(2)
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- ITAA 1997 Subdiv 328-D
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- ITAA 1997 Subdiv 328-G
- ITAA 1997 328-105
- ITAA 1997 328-105(1)(a)
- ITAA 1997 328-185
- ITAA 1997 328-190
- ITAA 1997 328-285(1)
- ITAA 1936 Div 3 – Pt III
- ITAA 1936 82KL
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZME
- ITAA 1936 82KZME(1)
- ITAA 1936 82KZME(2)
- ITAA 1936 82KZME(3)
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZME(7)
- ITAA 1936 82KZMF
- ITAA 1936 82KZMF(1)
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)

Case references:
- FCT v. Lau 84 ATC 4929

ATO references:
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