PR 2002/5 - Income tax: Karri Oak Project No.2 (Stage 3) Revised Arrangement

Product Ruling
Income tax: Karri Oak Project No.2 (Stage 3) Revised Arrangement

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Preamble

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

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 laws' 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 'Karri Oak Project No.2 (Stage 3) Revised Arrangement' or simply as 'the Project'.

Tax laws

2. The tax laws 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 70 (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, apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning

reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

Date of effect

11. This Ruling applies prospectively from 16 January 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 2005. 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 3 August 2001;
- The Karri Oak Vineyard Project No.3 Prospectus, dated 24 January 2001;
- The Karri Oak Project No. 2 (Stage 3) Supplementary Prospectus dated 6 February 2001;
- The Karri Oak Project No. 2 (stage 3) Second Supplementary Prospectus dated 28 February 2001;

- The Karri Oak Project No. 2 (stage 3) Third Supplementary Prospectus dated 4 April 2001;
- The Karri Oak Project No. 2 (Stage 3) Draft Fourth Supplementary Prospectus undated ;
- Further Amended Constitution for the Karri Oak Project No.2, dated 16 January 2001;
- First Supplemental Deed for the Karri Oak Project No.2 dated 16 January 2001;
- **Lease and Management Agreement for the Karri Oak Vineyard Project No.3 between Frankland Valley Company Ltd [the 'Responsible Entity'], Karri Oak Holdings Ltd ['the Lessor'] and the Grower, undated;**
- Amended Compliance Plan for the Karri Oak Vineyard Projects No. 2 & 3 dated 16 January 2001;
- Additional correspondence dated 28 September 2000, 14 November 2000, 15 November 2000, 9 February 2001, 28 February 2001, 3 August 2001, 12 October 2001 and 19 December 2001.

Note: Certain information received from the applicant has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

15. The documents highlighted are those that the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or an associate of the Grower will be a party to that are part of the arrangement to which this Ruling applies.

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

Overview

17. This arrangement involves the Karri Oak Project No.2 (Stage 3) Revised Arrangement.

Location	South West Region of Western Australia, near Mt Barker.
Type of business each participant is carrying on	A commercial viticulture and wine production business.

Number of hectares under cultivation	6.6 hectares
Size of each Leased Area	0.2 hectares
Number of vines per hectare	1,540
Expected production	11.5 tonnes / hectare
The term of the investment	19 years
Initial cost	$13,255
Initial cost per hectare	$66,275
Ongoing costs	Annual Management Fees and Lease fees (Rent).

18. The Project Land is situated in the South West Region of Western Australia. Karri Oak Holdings Ltd is the owner of the property. The original Prospectus offered 90 Leased Areas in the Project, of which 26 Leased Areas were allotted by 31 May 2001. Of the remaining 64 Leased areas, 33 will be offered for subscription under the Supplementary Prospectus. These Leased Areas have recently been planted with vines, trellised and have had irrigation installed by the Responsible Entity.

19. Growers applying under the Supplementary Prospectus enter into a Lease and Management Agreement. The Lease and Management Agreement gives a Grower a lease from Karri Oak Holdings Ltd, over an identifiable area of land called a 'Leased Area', until the Project is terminated on the date on which the last of the Growers has been advised that the fruit produce from each 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, not later than 30 June 2020. Each Leased Area is 0.2 hectares in size.

20. Karri Oak Holdings Ltd will lease the Leased Area to the Grower to enable the Grower to carry on a commercial business of growing grapes on the Leased Area for the sale of grapes and grape produce. Growers are specifically granted rights to collect and market the collectable produce from time to time on their Leased Area for this purpose.

21. There is no minimum subscription for this Project. Each investor may subscribe for a minimum of one Leased Area, at a cost of $13,255 per Leased Area. A minimum of 308 vines per Leased Area (1540 vines per hectare) have been planted by the Lessor, Karri Oak Holdings Ltd.

22. Growers will execute a Power of Attorney enabling the Responsible Entity, Frankland Valley Co. Ltd, to act on their behalf as required, when they make an application for a Leased Area. Applications under this Project will not be accepted from Growers

after 23 February 2002, the expiry date of the Fourth Supplementary Prospectus.

Amended Constitution

23. The Amended Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Grower and to manage the Project. The Responsible Entity will keep a register of Growers (cl 20). Growers are entitled to assign their Grower's Interest in certain circumstances (cl 17.1). The Lease and Management Agreement is annexed to the Constitution and will be executed on behalf of a Grower following them signing the Application and a Power of Attorney Form in the Prospectus. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance plan

24. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Act 2001. Under the Amended Compliance Plan, a Compliance Committee will monitor to what extent the Responsible Entity meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

Interest in land

25. A lease is granted by the Land Owner, Karri Oak Holdings Ltd, to the 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 Areas for carrying on the business of a long term commercial viticulture project (cl 5.2). Growers must pay rent annually to the Lessor. The term of a Grower's lease is up to 30 June 2020.

Lease and Management Agreement

26. Each Grower enters into a Lease and Management Agreement with the Responsible Entity for each Leased Area. The termination of the Project will be the date on which the last of the Growers has been advised that the fruit produce from each 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, not later than 30 June 2020.

27. Growers contract with the Responsible Entity to train, maintain, supervise and manage, in accordance with good commercial practice all the vines, the vineyard and the commercial viticultural

activities to be carried on by the Grower on the Leased Area. Growers pay a Management Fee for each Leased Area on subscription and an annual management fee thereafter.

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

- ensure the Lessor has planted sufficient rootlings or cuttings on the Leased Area;
- cultivate, tend, train, prune, fertilise, replant, spray and otherwise care for the vines as and when required;
- maintain the irrigation system to the vines on the Leased Area;
- maintain and repair the trellising systems to support the vines;
- 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;
- replace any vines that fail to establish or that die during the first 12 months of the project; and
- harvest the fruit grown on the Leased Area each year and deliver it up for sale.

29. Growers may elect to collect and market their own harvested collectable produce (cl 69.1). However, where Growers do not elect, the Responsible Entity will harvest and market the fruit produce from the Leased Area to obtain the highest practicable price for the fruit produce from the vineyard and to ensure that in all other respects any agreement for sale or marketing entered into is in the best interests of the Grower (cl 70.2).

30. Growers will only be offering up for sale the fruit grown on their Leased Area and will not be involved in purchasing in fruit from other sources.

31. The Responsible Entity will be responsible for paying for the cost of annual insurance against public risk in respect of the vineyard (cl 21.1.1).

32. The Responsible Entity will, if requested by the Grower, use its best endeavours to arrange insurance of the Leased Area (including the vines on or fruit produce from the Leased Area) on behalf of the Grower against destruction or damage by fire. This insurance, to be paid for by the Grower, will compensate for any loss of produce from the vines which would be assessable income to the Grower (cl 21.1.2).

Fees

33. The initial fee payable under the Lease and Management Agreement is the Subscription Sum of $13,255 per Leased Area payable on application. This includes a management fee of $12,595 for the care and cultivation of the vines (item 3 of Schedule to the agreement). This service will be carried out by 30 June 2002.

34. A Management Fee of $2,420 is payable on or before 31 July 2002 for services to be carried out in the period 1 July 2002 to 30 June 2003. A Management Fee of $1,760 is payable on or before 31 July 2003 for services to be carried out in the period 1 July 2003 to 30 June 2004.

35. For the year commencing 1 July 2004 and for each subsequent year, an annual Management Fee, equal to the previous years management fee PLUS the greater of 3% of the previous years management fee or the percentage increase in the Consumer Price Index (All Groups, Perth) between the quarter ending 30 June 2001 and the quarter ending 30 June prior to the date of payment, is payable for the period 1 July to 30 June and is payable on or before 31 July of the year in which the services are provided.

36. A Lease Fee of $660 is payable on application for rent for the period up to 30 June 2002. An annual Lease Fee of $660 is payable on or before 31 July of each year, for rent on the Leased Area for the periods 1 July 2002 to 30 June 2003 and 1 July 2003 to 30 June 2004.

37. For the year commencing 1 July 2004 and for each subsequent year, an annual rental fee is payable on or before 31 July of the year in which the services are provided and is to be calculated in accordance with the formula:-

A = $660 x B/C

Where A = the rent payable; B = the Consumer Price Index (All Groups, Perth) for the March quarter prior to calculations; and C = the Consumer Price Index (All Groups, Perth) for the March quarter in 2003.

This annual fee is first payable on or before 31 July 2004.

38. The Application Monies will be held in a trust account on trust for the Grower (cl 9.5.1 of the Constitution).

Cultivation and Harvesting

39. The 33 Leased Areas available for subscription under the Supplementary Prospectus have recently been planted with vines, trellised and have had irrigation installed by the Responsible Entity. The Responsible Entity will maintain the vines in accordance with good commercial practice. The services to be provided by the

Responsible Entity over the term of the Project are outlined in the Schedule to the Lease and Management Agreement (item 9).

40. The Harvest shall take place commencing from the date of the first commercially harvestable fruit crop from the vineyard, at such time or times as in the opinion of the Responsible Entity will maximise the price receivable for such fruit produce. For Non-Electing Growers, the Responsible Entity will be responsible for arranging the marketing and sale of the fruit produce.

41. The proceeds from the sale of the fruit produce from the vineyard will be paid into a separate produce fund. Proceeds received by the Responsible Entity are to be distributed in the following order of priority:

- to the Responsible Entity for any amounts it is entitled to under clause 34.4 of the Constitution;
- any annual contributions from prior years for any of the non-electing growers that may be due but unpaid;
- any annual contributions due and payable by non-electing growers under clause 23 for the succeeding financial year;
- any amounts payable by the non-electing growers under the Lease and Management Agreement or the Constitution; and
- the balance of the produce fund to each of the non-electing growers in proportion to their interest in the fund.

Finance

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

43. This Ruling does not apply if the finance arrangement entered into by the Grower 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

Application of this Ruling

44. This Ruling applies only to Growers who are accepted to participate in the Project on or before 30 June 2002 and who have executed a Lease and Management Agreement before that date. The Grower's participation in the Project must constitute the carrying on of a business of primary production. 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.

The Simplified Tax System ('STS')

Division 328

45. For a Grower participating in the Project, the recognition of income and the timing of tax deductions, including those related to capital allowances, 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

46. 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 '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.

Tax outcomes for Growers who are not 'STS taxpayers'

Assessable Income

Section 6-5

47. 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.

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

Trading stock

Section 70-35

49. A Grower who is not an 'STS taxpayer' may, in some years, hold grapes, grape juice and/or bottles of wine 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.

50. 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, Lease fees, and Interest

Section 8-1

51. A Grower who is not an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

Fee Type	ITAA 1997 Section	Year ended 30/6/2002	Year ended 30/6/2003	Year ended 30/6/2004
Management Fee	8-1	$12,595 – See Notes (i) & (ii) (below)	$2,420 – See Notes (i) & (ii) (below)	$1,760 – See Notes (i) & (ii) (below)
Lease fee (Rent)	8-1	$660 – See Notes (i) & (ii) (below)	$660 – See Notes (i) & (ii) (below)	$660 – See Notes (i) & (ii) (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 114;

(ii) The Management fees and the Lease fees shown in the Lease and Management Agreement are deductible in full in the year that they are incurred. However, if a Grower **chooses** to prepay fees for the doing of a thing (e.g., the provision of management services or the leasing of land) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA 1936 may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraph 91 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than $1,000.

Tax outcomes for Growers who are 'STS taxpayers'

Assessable Income

Section 6-5

52. 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.

53. 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

Section 328-285

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

55. Alternatively, a Grower who is an 'STS taxpayer' may instead choose to account for trading stock in an income year under the provisions of Division 70 (subsection 328-285(2)).

Deductions for Management fees, Lease fees, and Interest

Section 8-1 and section 328-105

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

Fee Type	**ITAA 1997 Sections**	**Year ended 30/6/2002**	**Year ended 30/6/2003**	**Year ended 30/6/2004**
Management Fee	8-1 & 328-105	$12,595 – See Notes (iii), (iv) & (v) (below)	$2,240 - See Notes (iii), (iv) & (v) (below)	$1,760 - See Notes (iii), (iv) & (v) (below)
Lease fee (Rent)	8-1 & 328-105	$660 – See Notes (iii), (iv) & (v) (below)	$660 - See Notes (iii), (iv) & (v) (below)	$660 - See Notes (iii), (iv) & (v) (below)

Notes:

(iii) 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 114;

(iv) If, for any reason, an amount shown in the Table above is not fully paid in the year in which it is incurred by a Grower who is an 'STS taxpayer' then the amount is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount shown in the Table above which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid;

(v) Where a Member who is an 'STS taxpayer', pays the Management Fees and the Lease fee in the relevant income years shown in the Lease and Management Agreement, those fees are deductible in full in the year that they are paid. However, if a Grower **chooses** to prepay fees for the doing of a thing (e.g., the provision of management services or the leasing of land) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA may apply to apportion those fees (see paragraphs 85 to 91). In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraph 91, unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules, and is deductible in full in the year in which it is incurred. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than $1,000.

Tax outcomes that apply to all Growers

57. 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 should read the discussion of the prepayment rules in paragraphs 85 to 91 (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 Grower's choice.

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

Section 35-55 – Commissioner's discretion

58. For a Grower who is an individual and who enters the Project during the year ended 30 June 2002 the rule in section 35-10 may apply to the business activity comprised by their involvement in this

Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2002 to 30 June 2003 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.

59. 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 (see paragraph 102 in the Explanations part of this ruling, below);
- a Grower's business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45;
- 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).

60. Where, the exception in subsection 35-10(4) applies, 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 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.

61. 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 82KZME – 82KZMF, 82KL, and Part IVA

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

- expenditure by a Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 85 to 98);

- 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?

63. For the amounts set out in the Tables above to constitute allowable deductions the Grower's viticulture activities as a participant in the Karri Oak Project No.2 (Stage 3) Revised Arrangement 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.

64. For schemes such as that of the Karri Oak Project No. 2 (Stage 3) Revised Arrangement, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of 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.

65. 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 licence) 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.

66. In this Project, each Grower enters into a Lease and Management Agreement.

67. Under the Lease and Management Agreement each individual Grower will have rights over a specific and identifiable area of land. The 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 Responsible Entity to come onto the land to carry out its obligations under the Lease and Management Agreement.

68. Under the Lease and Management Agreement the Responsible Entity is engaged by the Grower to establish and maintain a Leased Area on the Grower's identifiable area of land during the term of the Project. The Responsible Entity has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the Leased Area on the Grower's behalf.

69. The Responsible Entity is also engaged to harvest and sell, on the Grower's behalf, the grapes grown on the Grower's Leased Area.

70. 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 Project's description for all the indicators.

71. 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.

72. The pooling of grapes grown on the Grower's Leased Area 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 Leased Area.

73. The Responsible Entity's services on the Grower's behalf are also consistent with general viticulture practices. While the size of a Leased Area is relatively small, it is of a size and scale to allow it to be commercially viable. (see Taxation Ruling IT 360).

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

75. 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 Karri Oak Project No. 2 (Stage 3) Revised Arrangement will constitute the carrying on of a business.

The Simplified Tax System

Division 328

76. 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.

77. 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

78. 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.

79. The Management Fees and Lease 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 wine) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. There is no capital component of the Management Fee. The tests of deductibility

under the first limb of section 8-1 are met. The exclusions do not apply.

Possible application of prepayment provisions

80. Under the Lease and Management Agreement, neither the Management Fees nor the Lease fees are for things to be done beyond 30 June in the year in which the relevant amounts are incurred. In these circumstances, the prepayment provisions in sections 82KZME and 82KZMF have no application to these fees.

81. However, where a Grower chooses to prepay these fees for a period beyond the income year in which the expenditure is incurred, the prepayment provisions (see paragraphs 85 to 91) will apply to determine the amount and timing of the deductions regardless of whether the Grower is an 'STS taxpayer' or not. These provisions apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes 'STS taxpayers' from the operation of section 82KZMF. This is subject to the 'excluded expenditure' exception. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than $1,000.

Timing of deductions

82. In the absence of any application of the prepayment provisions, the timing of deductions for the Management Fees or the Lease fees will depend upon whether a Grower is an 'STS taxpayer' or is not an 'STS taxpayer'.

83. If the Grower is not an 'STS taxpayer', the Management Fees and the Lease fees are deductible in the year in which they are incurred.

84. If the Grower is an 'STS taxpayer' the Management Fees and the Lease fees are deductible in the income year in which they are paid, or are paid for the Grower (paragraph 328-105(1)(b)). If any amount that is properly incurred in an income year remains unpaid at the end of that income year, the unpaid amount is deductible in the income year in which it is actually paid or is paid for the Grower.

Prepayment provisions

Sections 82KZL to 82KZMF

85. 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 (e.g., 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.

86. For this Project only section 82KZL (an interpretative 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

87. Where the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

88. 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.

89. 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.

90. 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.

91. 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.

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

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

92. In this Project, an initial Management Fee of $12,595 and an initial Lease Fee of $660 per Leased Area will be incurred on the execution of the Lease and Management Agreement. The Management Fee and Lease fee are charged for providing management services Grower by 30 June of the year of execution of the Lease and Management Agreement. Under the Lease and Management Agreement, further annual expenditure is required each year during the term of the Project for the provision of management services until 30 June in those years.

93. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the initial management

fee has been inflated to result in reduced fees being payable for management fees in subsequent years.

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

95. On this basis, provided a Grower incurs expenditure as required under the Project agreements, as set out in paragraphs 33 to 37, then the basic precondition in subsection 82KZME(2) is not satisfied and, in these circumstances, section 82KZMF will have no application.

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

96. Although not required under the Lease and Management Agreement, a Grower participating in the Project may **choose** to prepay fees/interest for a period beyond the 'expenditure year'. Similarly, Growers who use financiers may either choose, or be required to prepay interest. Where this occurs, contrary to the conclusion reached in paragraph 95 above, section 82KZMF will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

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

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

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

99. 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.

100. 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.

101. 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.

102. 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.

103. 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).

104. 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 in the Project of one Leased Area during the year ended 30 June 2002 is unlikely to pass one of the tests until the year ended 30 June 2006. Growers who

acquire more than one Leased Area may however, find that their activity meets one of the tests in an earlier income year.

105. 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.

106. 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.

107. Information provided with this Product Ruling indicates that a Grower who acquires the minimum investment of one Leased Area 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 2004. 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 2003. Subsection 35-55(2) prevents the Commissioner exercising the discretion beyond this year.

108. 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 107) in the manner described in the Arrangement (see paragraphs 14 to 43). 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 8) 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.

109. 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:

- independent, objective and generally available information relating to the viticulture industry which substantially supports cash flow forecasts and other

claims, including prices and costs, as described by the independent experts in the Prospectus, and in the Product Ruling application submitted by the Responsible Entity.

Section 82KL

110. 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

111. 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).

112. The Karri Oak Project No.2 (Stage 3) Revised Arrangement 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 51 and 56 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.

113. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. 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

114. 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:

$^{1}/_{11}$ 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:

$^{1}/_{11}$ 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).

Detailed contents list

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

Commissioner of Taxation
16 January 2002

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
TR 2000/8; PR 1999/95; TR 92/1; TR 92/20; TR 97/11; TR 97/16; TD 93/34; TR 98/22; IT 360

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:
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 17-5
- ITAA 1997 Division 27
- ITAA 1997 Division 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 40-535
- ITAA 1997 Div 70
- ITAA 1997 70-35
- ITAA 1997 Div 328
- ITAA 1997 Subdiv 328-F
- ITAA 1997 Subdiv 328-G
- ITAA 1997 328-105
- ITAA 1997 328-105(1)(a)
- ITAA 1997 328-105(1)(b)
- ITAA 1997 328-285
- ITAA 1997 328-285(1)
- ITAA 1997 328-285(2)
- ITAA 1936 Div 3 of Part 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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