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Corking of WET to Leave Small Producers Wilting on the Vine?

By Brett Zimmermann & John Tucker

Though it has been accepted by Treasury that the wine equalisation tax (WET) rebate was originally introduced to support wine producers in rural and regional Australia, last night's announced budget changes to the rebate seem anything but that.

To supplement your reading of other published WET rebate summary pieces, we thought to provide our own views and analysis of the three principal measures announced. These comments reflect our understanding of the legislation in this area and its practical application in both a business structuring and ATO administration context, and we hope are additionally insightful:

i) "Strengthening" of Associated Producer rules;

ii) Phased WET rebate reduction; and

iii) "Tightening" of WET Rebate Eligibility.

We do not provide comment on the announced additional support to be provided for export and regional wine growers.

1. "Strengthening" of Associated Producer rules

In our experience in acting for wine clients, a primary area of focus of the ATO has been their review of the relationship between separate wine producers, for if multiple wine producers are "associated producer" within the meaning of that expression in the legislation then the maximum available rebate is to be shared between them – they cannot each claim the full rebate. Consequently, given each separate producer has (until last evening) been entitled to a maximum annual rebate of $500,000, the issue as to whether or not two (or more) producers are associated is significant, even more so now that it has been announced the provisions will be "strengthened".

To give proper context to the announcement and ahead of our speculation as what form the 'strengthening' will take (given the announcement contains no detail), it is appropriate that we provide a summary of the rules that we presently have.

In broad terms, to be an "associated producer" under the WET Act it is necessary:

- that the two producers are "connected with" each other; or
- for either or both producers to be under an obligation (formal or informal) or to be reasonably expected to act in accordance with the other (or a common third party) in relation to their financial affairs.

A producer will be "connected with" another producer if those two producers are connected within the meaning of that expression in s 328-125 of the *Income Tax Assessment Act 1997* (**the ITAA 1997**). Section 328-125 is a provision that connects two entities based on the level of control (direct or indirect) one has over the other, or the level of control a third entity has over the other two entities.

The required level of control is ordinarily 40%, however there are special rules, for example in the context of discretionary trusts, that can often deem a person to have control.

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Control additionally considers and includes the interest held by any "affiliate" of the relevant person, such that control is measured by reference to the interest held by the relevant person and also the interest held by any person who is an affiliate of that person.

This concept of who is and who is not an affiliate is central to the determination of whether a person is "connected with" another, and consequently whether or not one producer is an "associated producer" of the other. Whether or not a person is an affiliate of the other under s 328-130 of the ITAA 1997 is dependent upon whether or not a person acts, or might reasonably be expected to act, in accordance with the directions or wishes, or in concert with another in relation to the *business affairs* of the other.

Notwithstanding there being no assumed affiliated relationships under the existing legislation and that for there to be an affiliated relationship, supporting facts are required to evidence dependency or actual influence between the persons and their acting in concert, the ATO can (and has historically with varying degrees of success) assert the existence of affiliate relationships placing the burden of proof on the producer (not the ATO) upon objection, *disprove* dependency and/or acting in concert.

In light of this, last evening's Budget Announcement as to a 'strengthening' of the associated producer rules without giving any legislative detail has us only able to speculate on the methodology of any proposed changes.

For example, legislative amendment could take any one or more of the following forms:

- amending the definition of "connected with" in the income tax rules;
- amending the definition of "affiliate" in the income tax rules; or
- expanding the definition of "associated producer" in the WET Act to cover relationships which Treasury are particularly concerned with.

We would guess the third of these, however it will be extremely disappointing and frustrating if legislative amendment merely takes the form of giving the ATO more discretionary power to exclude relationships that they are uncomfortable with. Amongst other things, that would not provide any additional certainty than that which producers have presently.

Finally, we note that not only was the announcement silent as to the mechanics of its 'strengthening' of the associated producer rules, it was also silent as to date of effect on or from which these provisions will apply and whether, for example, there might be a transitioning between the current and the to-be-revised provisions in circumstances where for example, two or more producers become associated, but who may not have been previously. It would appear inequitable absent the detail of those provisions, for the amending provisions to have immediate effect, and for a producer having in good faith claimed a rebate to be found to have over claimed and be required to immediately refund the excess with interest and penalties.

From a planning perspective it may be that some producers will now or soon, be inadvertently caught up as associated producers, one with another from a WET rebate perspective, but may be able to be restructured to ensure their continued independence.

2. Phased rebate reduction

As reported in all media and you will all presumably be aware, from 1 July 2017, the WET rebate cap will be reduced from $500,000 to $350,000, and from 1 July 2018 to $290,000.

This announcement was effectively foreshadowed and accordingly not particularly surprising.

3. Tightened WET Rebate Eligibility

Treasury has stated that it will introduce amendments to the WET Act that will, with effect from 1 July 2019, 'tighten' (ie, restrict) the rules regarding eligibility to wine producers who in order to access the WET rebate must:

- "own an interest in a winery" or "have a long term lease over a winery"; **<u>and</u>**
- sell packaged, branded wine domestically.

We have added emphasis to the word "and" noting that the announced eligibility rules go beyond that which we believe were entertained by the Winemakers Federation of Australia (WFA) and the Wine Grape Growers Association (WGGA) in their joint submission to the Federal Government's Discussion Paper last year on the future of the WET rebate.

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We too lodged a submission in response to that Discussion Paper (read here), which as noted further below the Report from which was today only just released.

It is accepted and we would agree that a tightening of the provisions is required to curb the use of 'virtual winemakers'. On the face of the Budget papers and the Assistant Treasurer's statements on the issue however, the tightening will additionally hit, for example, those producers who own or lease a vineyard, and who convert grapes they own to wine for bulk trade (for example, when the choice may between picking and converting uncontracted grapes to wine, and picking'n'dropping those grapes on the ground to die). It will also additionally hit for example wine producers who market and sell their own branded product and have their own cellar door outlet, but utilise the services of a contract wine processor!!

We have not seen a case made to prohibit their access to the rebate. If the concern of Treasury is just around the exploitation of the provisions as illustrated in ATO published Tax Alerts there remain avenues to target these without such broad sweeping provisions.

Consequently, the tightening of the rebate appears as much, if not more, a reduction in spend and increase in budget savings than about curbing the use of virtual winemakers.

The Assistant Commissioner has noted that the final details on the tightened eligibility criteria, including the definition of 'winery', will be resolved through further consultation.

So it remains to be seen whether 'winery' will be expanded to include, for example, significant vineyard infrastructure. Also whether the "and" might become an "or", though that can be assured doubtful.

As a technical aside, given the lack of detail in the announcement we rhetorically query whether the eligibility criteria will apply and be limited to the entity seeking to claim the rebate – being an amendment presumably to s 19-5 of the WET Act, such that once the entity qualifies for being an eligible producer (for lack of better expression) they will be able to claim the rebate with respect to all of their otherwise rebateable wine, and/or whether the eligibility will apply to the specific product itself. The answer to this will be of particular interest to wineries who, in addition to selling their own branded product, sell unbranded wine stock of theirs to other producers. We assume the criteria will apply to a combination of both, though it remains to be seen.

Given the provisions are said to only have application from 1 July 2019 we don't see them being a huge legislative priority, however we will keep watch and comment when they appear.

Finally, we note that Treasury has just a few moments ago released its "Wine Equalisation Tax Rebate Consultative Group Report" - albeit dated October 2015. The delay in publication can only be presumed to be intentional, and it makes interesting reading for some of its differences to the announcements made in last night's budget.

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