WINE INDUSTRY FOCUS GROUP

INDIRECT TAXES & INCENTIVES

TAX LAWS AMENDMENT (WINE PRODUCER REBATE & OTHER MEASURES) BILL 2004

A Brief Issues Paper

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Introduction

This Paper outlines some concerns expressed by members of Ernst & Young's Wine Industry Focus Group and our clients in relation to measures proposed in the *Tax Laws Amendment (Wine Producer Rebate & Other Measures) Bill 2004* ('the Bill').

Comments in this Paper are limited to those which arise from a tax policy or tax drafting perspective, or from the practical implementation of the proposed measures. Our comments do not extend to any issues of a broader economic, international relations, environmental or social policy perspective.

Further, our comments are restricted to the impact of the measures contained in the Bill on the *A New Tax System (Wine Equalisation Tax) Act 1999* ('the WET Act'). Therefore our comments are not directed towards the measures contained within Schedule 3 of the Bill, concerning the abolition of accelerated depreciation for grape vines.

We encourage the opportunity for the contents of the Bill to be further discussed and considered.

Schedule 1 - The Wine Producer Rebate Measures

These measures have been broadly welcomed by the Australian wine industry and its representative bodies, notably the Winemakers Federation of Australia. Ernst & Young's Wine Industry Focus Group and its clients are also broadly welcoming of the measures contained in the Bill. This is regardless of the fact that, typically, our clients are of a size whereby they will continue to pay significant amounts of WET into the future, even after claiming the maximum $290,000 per annum WET rebate.

Whether these clients will be financially advantaged or disadvantaged as a result of the measures contained in the Bill is largely a result individual circumstances and dependant upon whether or not each of the States decide to continue with the States 15% cellar door subsidy schemes.[1]

Regardless of whether the measures contained in the Bill have a direct positive or negative financial impact on our clients however, they generally support the measures contained in the Bill. Notwithstanding this general support, a number of concerns have still arisen, and we have been requested to raise them on our clients' behalf.

1. Small Wineries Selling via Distributors

The intention of the provisions in Schedule 1 of the Bill which make amendments to Section 19 of the WET Act are to relieve wine produced by smaller wineries from WET. The Explanatory Memorandum to the Bill notes at paragraph 1.3:

> *. . . 'this effectively exempts from WET $1 million (wholesale value) of each producers domestic wine sales per financial year'*

We note however, that in many circumstances wine produced by smaller producers will still be subject to significant amounts of WET.

A number of smaller wineries lack the time, resources, scale and/or contacts within the retail industry to sell their wine directly to retailers. It therefore is very common and makes commercial sense for these smaller wineries to appoint a distributor to purchase wines and sell them on their behalf. Such distributors purchase wine from a number of smaller wineries and sell these by wholesale to retail outlets. In these circumstances no WET is payable on the sale of wines between the winery and the distributor. This is because the sale is not a taxable dealing at that time. [2] The WET is payable on the subsequent sale by the distributor to a retail outlet.

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[1] Noting that we are aware that both the Victorian and New South Wales State Governments have announced the continuation of existing arrangements.

[2] A sale is not taxable if the purchaser (the distributor) quotes for the sale (Section 7-10, WET Act). The purchaser would be entitled to quote for its purchase of wine pursuant to Section 13–5 (1)(a) of the WET Act).

The new rebate arrangements contained in Schedule 1 to the Bill will provide the purchaser a rebate equal to 29% of the selling price of the wine. [3] However, no further rebate is available when the distributor subsequently sells that wine to a retailer. [4] In this way the distributor's mark up is subject to WET. This is demonstrated in the example below.

	Current Arrangement	Proposed Arrangement (Assuming Producer Keeps Rebate)	Proposed Arrangement (Assuming Rebate Passed On, Constant $ Distribution Margin	Proposed Arrangement (Assuming Rebate Passed On, Constant % Distributor Mark Up
Winery Sale Price [1]	$120.00	$120.00	$120.00	$120.00
WET	0.00	($34.80) [2]	($34.80)	($34.80)
Distributor Purchase Price	$120.00	$120.00 [3]	$85.20	$85.20
Distributor Margin	$60.00	$60.00	$60.00	$42.60 [4]
Distributor Sell Price	$180.00	$180.00	$145.20	$127.80
WET @ 29%	$52.50	$52.50	$42.11	$37.06
Retailer Purchase Price	$232.20	$232.20	$187.31	$154.86
Total WET Paid	**$52.20**	$52.20 less $34.80 = **$17.40**	$42.11 less $34.80 = **$7.31**	$37.06 less $34.80 = **$2.26**

NOTES TO TABLE:

1. All amounts are expressed as dollars per case.
2. Rebate payable to producer.
3. As this scenario assumes the producer is able to retain the benefit of the rebate, there is no reduction to the distributor's purchase price.
4. Assumes 50% distributor mark up, as per current arrangements.

All amounts and transaction values are assumed to be GST exclusive. As any GST levied on the sale between distributor and winery would, in ordinary circumstances, be fully creditable to the retailer, the impact of GST may be ignored in this analysis.

As can be seen from the above example, wine sold by a small winery via a distributor will be subject to some level of WET. The exact quantum of this WET liability depends upon a number of scenarios, including whether the effective benefit of the producer rebate is able to be maintained by the winery (or is 'passed on' to the distributor and perhaps to the retailer) and whether distributors are assumed to operate on a constant dollar mark up basis or upon a constant percentage mark up basis.

This example is intended to show that the assistance provided to smaller wineries through the proposed wine producer rebate amendment, do not operate to 'exempt' wine produced by small wineries from WET.

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[3] See proposed new subsection 19-5(b) of the WET Act.
[4] As producers rebates are only claimable by 'producers. See proposed Section 19-5 and the proposed new definition of producer contained in the Bill.

This potentially means that the positive impact the new amendments will have on smaller wineries may not be as significant as first contemplated by the Government in proposing the amendments.

Schedule 2 - Compliance Improvement Measures

Schedule 2 of the Bill contains measures aimed to 'address certain compliance and administrative issues arising from the legislation.'[5] We note below a number of concerns in relation to these measures of those measures is described as 'Confirming Wine Packaging in Tax Base.'[6]

The intended application of the amendments is set out in paragraphs 2.2 to 2.6 of the Explanatory Memorandum. These are reproduced below:

'2.2 The wine equalisation tax (WET) applies at the rate of 29% of the final wholesale sale of wine, or a nominal equivalent, in the absence of an exemption.

2.3 Historically, wine has been sold by the wine produce after it has been packaged as for retail sale, and WET has included a component drawn from wine packaging in containers such as bottles and casks.

2.4 However, some large retailers who are able to buy wine in bulk volumes may do so and then package the wine for retail sale themselves. In doing so wine tax is not applied to the packaging component of the wine product.

2.5 The intention of this measure, though referring to the placing of wine in containers after the point of wholesale sale in the amendments, is to address the nature of costs incurred in the necessary processes to prepare the wine to reach the point of retail sale. It does not encompass the packaging of wine at the time of retail sale, such as putting wine in paper bags or utilising containers of the retail purchaser.

2.6 Further, the amendments reflect that the measure does not intend to impose a WET liability, for the wine packaging component, on organisation that undertake bottling/labelling/packaging activities for non-commercial purposes, such as for fundraising as part of a charity.'

Members of Ernst & Young's Wine Industry Focus Group and its clients appreciate the policy intent underlying the new measures as expressed in the Explanatory Memorandum.

Whilst not being fully aware of the extent to which retailers are currently availing themselves of the opportunity existing in the current WET legislation (as outlined in the Bill, but towards which the new measures are directed), we can appreciate the Government's concerns regarding the potential for revenue leakage and possible 'uneven playing fields.' We note that such 'uneven playing fields' can develop both:

- Between retailers who structure their arrangements in this manner and those who do not; and
- between suppliers who are prepared to accommodate such arrangements for the benefit of retailers and those who are not.

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[5] Explanatory Memorandum to the Bill, page 3.
[6] Heading to Chapter 2 of the Explanatory Memorandum, page 11

Nevertheless, our clients have raised a number of issues regarding the drafting of these amendments.

2. Definition of 'Container'

The Bill introduces a new Assessable Dealing AD15, at the end of the Assessable Dealings Table at Section 5-5 of the WET Act. This Assessable Dealing applies to the 'retail sale, in the course of any business, of wine that is placed in containers at a time after wine tax became payable on the wine by a person other than the seller'.

The term *container* is defined in Division 33 of the WET Act in the following terms:

'***Container*** means:

(a) packaging in which, or with which, any property (the *contents*) is packed or secured, in the ordinary course of a business, for the purpose of the marketing or delivery of the contents; and

(b) ancillary items that are packed or secured with the contents and are intended, and reasonably necessary, to allow or facilitate the use of the contents.'

Our clients are concerned that this definition is unacceptably broad when applied in the circumstances envisaged by the new amendments contained in the Bill. For example, a similar definition of 'container' was interpreted in a manner which involved items such as plastic bags, plastic knives and forks, serviettes, refresher towelettes, etc. in a significant wholesale sales tax case. [7]

In light of the obvious similarities between the structures, language and design of the WET Act and the former sales tax legislation, [8] we believe it is more than likely that a similarly broad interpretation would apply to the WET Act.

Given such a broad definition, our clients are concerned that the clear words in the Bill do not reflect the policy intention as outlined in the Explanatory Memorandum. We also note that unless the meaning of words contained in an Act are ambiguous, absurd or unreasonable there is no requirement for a court to refer to extrinsic materials, such as Explanatory Memoranda. [9]

For example, our clients are concerned that the clear meaning of the words contained in the new Assessable Dealing AD15 could apply to the placing of a bottle of wine into a brown paper bag, plastic bag or similar, by a retailer at the time of retail sale. The measures could potentially also equally apply to the placing of a number of bottles into an empty wine carton at the time of retail sale. Some of our clients are even concerned that the pouring of wine from a bottle into a glass by a restaurant or hotel in order to make a retail sale would also constitute the 'retail sale . . . of wine that

[7] FC of T v Kentucky Fried Chicken Pty Ltd and anor 88 ACT 4363. It is acknowledged that this case arose under the 'old' sales tax law (i.e. before the introduction of the 'streamlined' sales tax law from 1 January 1993), but the definitions are sufficiently similar for a similar interpretation to apply

[8] In particular the Sales Tax Assessment Act 1992.

[9] See Section 15AB of the Acts Interpretation Act 1901.

is placed in containers at a time after wine tax became payable . . . ' and so be caught by the new Assessable Dealing.

As paragraphs 2.2 to 2.6 of the Explanatory Memorandum make clear, this is not the intention of the Bill, but given the apparently clear meaning of the relevant terms in the proposed amendment, there is no requirement to make reference to that Explanatory Memorandum.

We therefore suggest that the wording of the proposed new Assessable Dealing needs to be altered, such that is clear that it is only the placement of wine into bottles (or perhaps other 'standard' containers such as casks) that will give rise to the new Assessable Dealing.

We further note that some retailers purchase wine in bulk and allow their retail customers to purchase refillable swing top bottles and have these refilled at the point of retail sale. We do not believe it is the intention of the Bill to alter the WET payable in such circumstances, and the Bill needs to reflect this.

3. Creation of 'Inappropriate' Ability to Lower WET Liability

As discussed above, the measures in Schedule 2 to the Bill introduce a new Assessable Dealing AD15. The taxable value to be applied to this proposed new Assessable Dealing is the 'notional wholesale selling price' of the wine sold by the retailer in these circumstances.

The notional wholesale selling price of wine is defined in subdivision 9-B of the WET Act as either the 'half retail price method' or the 'average wholesale price method'. The use of a notional wholesale selling price is to ensure that the Wine Equalisation Tax operates, as intended, as a tax on wholesale sales or upon the wholesale value of wine sold by retail or applied to own use.

However, we note that the creation of this new Assessable Dealing may be able to be used by retailers to reduce the amount of WET payable on wine sold by them.

It is conceivable that retailers could restructure their existing arrangements in order to purchase bulk, unbottled wine, have that wine subsequently packaged for retail sale and then account for WET based upon the notional wholesale selling price. Retailers could obtain a cash benefit by operating in this manner. This benefit will arise in situations where retailers have relatively low retail margins, meaning that the use of the half retail price method of calculating a notional wholesale selling price produces a value lower than the amount which would have been payable if WET had been calculated on the price for which the wine was purchased. [10] The following example illustrates the point.

> Consider the situation where a winery currently sells to a retailer for $100 plus $29 WET, for a total of $129 (again GST is ignored in this analysis). Further assume that that wine is currently sold by the retailer for $150 per case. No additional WET considerations arise.

[10] Noting that the half retail price method will generally be the only method available to retailers, as the average wholesale price method can only be used where the taxpayer makes wholesale sales.

> If that retailer was able to procure the same wine in an unpackaged form for the equivalent of $80 per case and incur $20 in bottling/packaging costs, it would pay, at the time of purchase, $23.20 in WET (29% of $80). Under the new provisions however, it would subsequently incur a WET liability based on its notional wholesale selling price at the time at which the wine was sold by retail. Based upon the half retail price method this liability would be calculated as 29% of $75, or $21.75. The retailer would be entitled to claim a credit of the WET borne at the time of purchase of the wine. [11] In these circumstances, the retailer would be entitled to a net credit for WET equal to $1.45 ($21.75 less $23.20) and the total of the net amount of WET payable on the case of wine has reduced by $7.25 per case (i.e. from $29.00 to $21.75). This net WET liability is even lower than the WET which would have been payable had the retailer entered into these post wholesale sale bottling arrangements under the existing law.

As this clearly gives rise to inappropriate outcome we do not believe this possibility has been properly contemplated by the drafters of the Bill.

4. Measures May Not be Effective Where Retailer Provides Packaging Materials

Ernst & Young's Wine Industry Focus Group members and our clients have also noted that the proposed measures may not be as effective as intended in some circumstances.

The measures are clearly designed to ensure that costs associated with the bottling, etc. of wine is included in the base upon which WET is calculated. However, participants in the industry are already aware that the proposed measures would not be effective where a retailer simply provides bottles to the winery and has the winery use those bottles (and potentially corks, caps, labels, etc.) in the packaging of the wine. Such an arrangement would not give rise to the proposed new Assessable Dealing ADI5. This is because the wine would have been placed in containers before WET became payable on the wine by the winery.

However, because the retailer had provided some or all of the packaging components, the price for which the winery would be prepared to sell the wine to the retailer would be reduced accordingly. Thus WET would effectively still not be paid on the value of packaging materials supplied by the retailer to the winery.

5. No quoting ground for retailers who acquire unbottled wine

We note that the WET legislation is intended to impose a single stage tax, normally intended to apply to the wholesale sale of wine. A system of quoting which allows purchasers in relevant circumstances to acquire wine free from WET, generally enables WET to be paid once, at the time of wholesale sale.

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[11] Pursuant to existing credit ground CR4 in the Wine Tax Credit Payable at Section 17-5 of the WET Act.

There are certain non-wholesale sales which give rise to Assessable Dealings for WET purposes. [12] However, in these circumstances the purchaser is generally able to quote when it purchases the wine, effectively avoiding double taxation and deferring the imposition of WET until the last Assessable Dealing. [13]

Whilst the proposed amendments create a new Assessable Dealing and therefore create a liability for retailers which did not previously exist, we note that there is no new quoting ground for retailers which purchase bulk wine in unpackaged form and then subsequently bottle that wine and sell by retail.

This means that the only form of relief from double taxation is via the credit mechanisms in Division 17 of the WET Act. The most appropriate Credit Ground applicable in these circumstances would be CR4 of the Wine Tax Credit Table in Section 17-5 of the WET Act.

Entitlement to a credit under this credit ground does not arise however, until the time of an Assessable Dealing which gives rise to a WET liability for wine in respect of which the taxpayer has already borne tax. Based upon the proposed amendments to the WET legislation, retailers who purchase wine in an unpackaged form would not be entitled to quote in respect of the purchase of that wine, and so would bear the cost of WET when it purchases wine. This additional cost would be reflected in increased carrying cost for inventory and would not be available as a credit until such time as the subsequent liability under AD15 arose when the wine sold by retail.

Whilst we note that the Commissioner may authorise taxpayers to quote in circumstances where taxpayers would not otherwise be entitled to quote, [14] we do not believe that the absence of a general quoting ground for bulk wine purchased subsequently bottled and then sold by retail, is appropriate.

The introduction of a quoting ground for wine purchased and dealt with in this manner would be a relatively simple measure which would greatly improve the operation of the new amendments and make them more consistent with the scheme of the WET legislation as a whole.

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[12] We particularly note Assessable Dealings AD2d and AD12d which relate to indirect marketing sales.

[13] In particular Section 13-5(1)(a) which allows a purchaser to quote where the purchaser has the intention of selling the wine by an indirect marketing sale.

[14] Refer Section 13-10 of the WET Act.

CONCLUSION

As discussed above, we believe that the measures contained in the Bill have some significant deficiencies.

Whilst it is clear that legislative change in respect of these areas is broadly appropriate, we do not believe that the Bill, in its current form, properly gives affect to the desired policy intent. We therefore respectfully request that this Bill be subject further discussion before it is passed. In this regard we note that the proposed amendments to the producer rebate provisions are intended to be effective from 1 October 2004. [15]. Delaying the introduction of the Bill until such time as the concerns raised by us have been addressed, would not therefore delay the benefit of these measures.

The more pressing concerns are in relation to the implementation of those measures contained in Schedule 2 to the Bill, designed to ensure the inclusion of packaging costs in the WET tax base. Such amendments are not proposed to be effective until the date on which the Bill receives royal assent. [16]

Thus, there would appear to be an opportunity for the provisions dealing with the wine producer rebates to be separated from those seeking to include packaging costs, etc. within the WET tax base. In this way, it would be possible for the producer rebate arrangements to be implemented more quickly, but for the implementation of the amendments in Schedule 2 of the Bill to be deferred until such time as they have been given the requisite further consideration.

We strongly believe that such further discussion and consideration would improve the effectiveness and integrity of the Bill, and the WET legislation generally.

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[15] See provision 2 of the Table headed 'Commencement Information' at Section 2 of the Bill.
[16] Provision 3 of the Table headed 'Commencement Information at Section 2 of the Bill.