PR 2008/56 - Income tax: KTC Mahogany Project 2008 (2008 Participants)

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Product Ruling

Income tax: KTC Mahogany Project 2008 (2008 Participants)

Contents Para

This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

No guarantee of commercial success

The Tax Office **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. 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 in the **Ruling** part of this document are available, **provided that** the scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document. If the scheme is not carried out as described, participants lose the protection of this Product Ruling.

Terms of use of this Product Ruling

This Product Ruling has been given on the basis that the entity(s) who applied for the Product 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 Product Ruling.

What this Ruling is about

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling section (below) apply to the defined class of entities, who take part in the scheme to which this Product Ruling relates. All legislative references in this Product Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated. In this Product Ruling this scheme is referred to as 'the scheme', the 'KTC Mahogany Project 2008', or simply as 'the Project'.

Class of entities

2. This part of the Product Ruling specifies which entities:

- are subject to the taxation obligations; and
- can rely on the taxation benefits;

set out in the Ruling section of this Product Ruling.

3. The members of the class of entities who are subject to those taxation obligations and who can rely on those taxation benefits are referred to in this Product Ruling as Participants.

4. Participants are those entities that:

- meet the definition of 'initial participant' in subsection 394-15(5); and
- are accepted to take part in the scheme specified below on or after the date this Product Ruling is made.

5. A Participant will have executed the relevant Project Agreements set out in paragraph 38 of this Product Ruling on or before 30 June 2008 and will hold a 'Forestry Interest' in the Project. In this Ruling, each of these Participants will be wholesale clients for the purposes of the *Corporations Act 2001*.

6. The class of entities who can rely on this Product Ruling does **not** include Participants who:

- are accepted into the Project before the date of this Product Ruling or after 30 June 2008;
- are not a wholesale client for the purposes of section 761G of the *Corporations Act 2001*;
- participate in the scheme through offers made other than through the Information Memorandum; or
- enter into finance arrangements with entities associated with the Project.

Superannuation Industry (Supervision) Act 1993

7. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA 1993). The Tax Office gives no assurance that the product is an appropriate investment for a superannuation fund. The trustees of superannuation funds are advised that no consideration has been given in this Product Ruling as to whether investment in this product may contravene the provisions of SISA 1993.

Qualifications

8. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 38 to 76 of this Ruling.

9. If the scheme actually carried out is materially different from the scheme that is described in this Product Ruling, then:

- this Product Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Product Ruling may be withdrawn or modified.

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Date of effect

11. This Product Ruling applies prospectively from 11 June 2008, the date this Product Ruling is made. It therefore applies only to the specified class of entities that enter into the scheme from 11 June 2008 until 30 June 2008 being the closing date for entry into the scheme. This Product Ruling provides advice on the availability of tax benefits to the specified class of entities for all income years up to the income year in which the scheme is terminated in accordance with the Project Agreements.

12. However the Product Ruling only applies to the extent that:

- there is no change in the scheme or in the entity's involvement in the scheme;
- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

13. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

14. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the ruling relates has not begun; and
- the scheme to which the ruling relates has not begun to be carried out.

15. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Changes in the Law

16. Although this Product Ruling deals with the laws enacted at the time it was issued, later amendments to the law may impact on this Product Ruling. Any such changes will take precedence over the application of this Product Ruling and, to the extent of those amendments this Product Ruling will be superseded.

17. Entities who are considering participating in the scheme 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

18. Product Rulings were introduced for the purpose of providing certainty about tax consequences for entities in schemes 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 Product Ruling is issued.

Goods and Services Tax

19. Should an 'initial participant' be entitled to an input tax credit in respect of fees and expenses that are allowable deductions under section 394-10, the deduction otherwise available under section 394-10 would be reduced by the amount of the entitlement (subdivision 27-A).

Ruling

Structure of the Project

20. The KTC Mahogany Project 2008 is a 'forestry managed investment scheme' as defined in subsection 394-15(1). Its purpose is the establishment and tending of mahogany (*Khaya senegalensis*) trees for felling in Australia.

21. Subject to the stated qualifications, this part of the Product Ruling sets out in detail the taxation obligations and benefits for an 'initial participant'[1] in the defined class of entities (see paragraphs 2 to 6 of this Ruling) who is accepted to participate in the 'forestry managed investment scheme' described at paragraphs 38 to 76 of this Ruling, between 11 June 2008 and 30 June 2008 inclusive.

22. An entity that takes part in the Project as a 'subsequent participant'[2] is not covered by this Product Ruling but may request a private ruling on their participation in the Project. A 'subsequent participant' is an entity that does not meet the definition of 'initial participant' in subsection 394-15(5).

Carrying on a business

23. An 'initial participant' in the Project is not considered to be carrying on a business of primary production.

The '70% DFE rule' and the establishment of the trees

24. The taxation obligations and benefits set out below have been determined using the information provided to the Commissioner by the Forestry Manager in Division 394. On the basis of that information the Commissioner has decided that on 30 June 2008 it will be reasonable to expect that the '70% DFE rule'[3] will be satisfied. The Tax Office may undertake review activities during the term of the Project to verify the information relied on for the purposes of the '70% DFE rule'.

25. The Product Ruling will only apply if the Forestry Manager establishes all of the trees that were intended to be established under the Project within 18 months of the end of the income year in which the first 'Participant' in the Project is accepted.[4] For this Project the trees must be established before 31 December 2009.

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[1] See subsection 394-15(5).
[2] See section 394-30.
[3] The '70% DFE rule' is set out in section 394-35.
[4] See subsection 394-10(4).

26. In the context of this Project, the trees will be established when they are planted on the land acquired for the purposes of the Project at the average rate of 500 trees per hectare. The Forestry Manager is required by section 394-10 of Schedule 1 of the TAA to notify the Tax Office if the trees are not established by 31 December 2009.

Allowable Deductions

Sections 8-5, 394-10 and 394-20

27. A Participant in the Project can claim deductions for the amounts shown in the Table below (on a **per 'Forestry Interest'** basis) that are paid to the Forestry Manager (sections 8-5 and 394-10).

Fee	**Amount**	**Income Year(s) deductible**
Initial Contribution	$7,500	2007-08
Deferred Contribution (for Tending costs for years 5 to 10)	5.5% of the Gross Harvest Proceeds from the sale of Timber from Trees	2017-18
Felling Costs	20.9% of the Gross Harvest Proceeds from the sale of Timber from Trees	2017-18
Marketing Costs	8.8% of the Gross Harvest Proceeds from the sale of Timber from Trees	2017-18

28. The deductibility of these amounts remains subject to a requirement that a CGT event[5] does not happen in relation to the Participant's 'Forestry Interest' before 1 July 2012 (see paragraphs 30 to 32 of this Ruling).

29. The amounts are deductible in the income year in which they are paid, or are paid on behalf of the Participant (subsection 394-10(2) and section 394-20). Where a Participant does not fully pay an amount, or it is not fully paid on their behalf in an income year, it is deductible only to the extent to which it has been paid. Any unpaid amount is then deductible in the income year or income years in which it is actually paid.

[5] Defined in section 995-1.

'CGT event' within 4 years for Participants who are 'initial participants'

Subsections 394-10(5) and 394-10(6) of the ITAA 1997 and section 170 of the Income Tax Assessment Act 1936

30. A deduction for the Initial Contribution is not allowable where a 'CGT event' happens in relation to the 'Forestry Interest' of a Participant before 1 July 2012 (subsection 394-10(5)).

31. Where a deduction for this amount has already been claimed by a Participant, the Commissioner may amend their assessment at any time within two years of the 'CGT event' happening (subsection 394-10(6)). The Commissioner's power to amend in these circumstances applies despite section 170 of the *Income tax Assessment Act 1936* (ITAA 1936).

32. Participants whose deductions are disallowed because of subsection 394-10(5) are still required to include in assessable income the market value of the 'Forestry Interest' at the time of the 'CGT event' or the decrease in the market value of the 'Forestry Interest' as a result of the 'CGT event'.

Interest on loans to finance the 'Forestry Interest' of a Participant

33. The deductibility or otherwise of interest incurred by Participants who finance their participation in the Project through a loan facility with an independent lender external to the Project is outside the scope of this Product Ruling. Such Participants may request a private ruling on the deductibility of loan interest or may self assess the deductibility of the interest.

Assessable income, 'CGT events' and the 'Forestry Interests' of Participants who are 'initial participants'

Sections 6-10 and 394-25

34. Where a 'CGT event' happens to a 'Forestry Interest' held by a Participant in this Project the market value of the 'Forestry Interest', or the decrease in the market value of the 'Forestry Interest', is included in the assessable income of the Participant (sections 6-10 and 394-25).

35. The relevant amount is included in the Participant's assessable income in the income year in which the 'CGT event' happens (subsection 394-25(2)).

36. 'CGT events' for these purposes include those relating to:

- a **clear-fell harvest of all or part of the trees** grown under the Project;
- the **sale, or any other disposal** of all or part of the 'Forestry Interest' held by the Participant; or

- any other 'CGT event' that results in a reduction of the market value of the 'Forestry Interest' held by the Participant.

Prepayment provisions, non commercial losses and anti-avoidance provisions

Division 35 of the ITAA 1997 and section 82KL and Part IVA of the ITAA 1936

37. Where a Participant is accepted to participate in the Project set out at paragraphs 38 to 76 of this Ruling, the following provisions have application as indicated:

- losses arising from participation in the Project are not within the scope of Division 35 of the ITAA 1997;
- section 82KL of the ITAA 1936 does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA of the ITAA 1936 will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Product Ruling.

Scheme

38. The scheme that is the subject of this Product Ruling is specified below. This scheme incorporates the following:

- Application for a Product Ruling as constituted by the following documents and additional correspondence including e-mails received on 4 February 2008, 18 February 2008, 22 February 2008, 4 March 2008, 19 March 2008, 11 April 2008, 14 April 2008, 18 April 2008, 23 April 2008, 29 April 2008, 1 May 2008, 16 May 2008, 19 May 2008, 21 May 2008, 26 May 2008, 30 May 2008, 2 June 2008 and 3 June 2008;
- Draft Information Memorandum for the KTC Mahogany Project 2008 issued by Kimberley Timber Corporation Ltd, received 3 June 2008;
- Draft Supplementary Information Memorandum #1 for the KTC Mahogany Project 2008 issued by Kimberley Timber Corporation Ltd, received 3 June 2008;
- Draft **Constitution** for the KTC Mahogany Project 2008 between Kimberley Timber Corporation Ltd and each Participant, received 30 May 2008;

- Draft **Forestry Management Agreement** for the KTC Mahogany Project 2008 between Kimberley Timber Corporation Ltd and each Participant, received 3 June 2008;
- Draft Forestry Contract for the KTC Mahogany Project 2008 between Kimberley Timber Corporation Ltd and KTC Plantation Management Pty Ltd (Forestry Contractor), received 30 May 2008;
- Draft Lease between the land owner (Lessor) and KTC Landbank Pty Ltd, received 30 May 2008;
- Draft Sub-Lease between KTC Landbank Pty Ltd (Land Company) and Kimberley Timber Corporation Ltd, received 30 May 2008; and
- Draft Intermediary Authorisation between Kimberley Timber Corporation Ltd and Primary Securities Ltd received 3 June 2008.

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

39. The documents highlighted (in bold) are those that a Participant may enter into. For the purposes of describing the scheme to which this Product Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Participant, or any associate of a Participant, will be a party to, which are a part of the scheme. The effect of these agreements is summarised as follows.

40. In accordance with the above documents, a Participant who participates in the scheme must be a wholesale client. This Ruling does not apply unless the Participant is a wholesale client as defined in section 761G of the *Corporations Act 2001*.

41. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

Overview

42. The main features of the KTC Mahogany Project 2008 are as follows:

Location	Ord River Irrigation Area, Western Australia
Species of trees to be planted under the scheme	*Khaya senegalensis* (African Mahogany)
Term of the Project	10 years
Date all trees are due to be planted on scheme land	31 December 2009

Number of trees per hectare	500
Size of the project	125 hectares
Minimum allocation of 'Forestry Interests' per Participant	2 Forestry Interests
Minimum subscription	No minimum subscription applies
Initial cost	$15,000 for two Forestry Interests
Other costs	Deferred contribution Extraordinary Event Contribution (certain circumstances) Felling costs Marketing costs Performance Bonus

43. The Project will involve establishing, tending, felling and harvesting mahogany (*Khaya senegalensis*) trees for the purpose of selling the timber.

44. The Project will be managed by Kimberley Timber Corporation Ltd (Forestry Manager).

45. Primary Securities Ltd as the holder of Australian Financial Service Licence 224107 will issue the interests in the Project as agent for the Forestry Manager.

46. An offer to participate in the Project will be made through an Information Memorandum (IM). The offer under the IM is for 125 hectares, which corresponds to 500 'Forestry Interests' in the Project.

47. An entity that participates in the Project as a Participant will do so by acquiring minimum of 2 Forestry Interests on or before 30 June 2008.

48. Applicants execute a Power of Attorney contained in the IM. The Power of Attorney irrevocably appoints the Forestry Manager to enter into, on behalf of the Participant, the Forestry Management Agreement and any other documents required to hold an interest in the Project.

49. For the purposes of this Product Ruling, Applicants who are accepted to participate in the Project and who execute the Forestry Management Agreement on or before 30 June 2008 will become Participants in the Project.

50. The Forestry Manager is seeking to lease land in the Ord River Irrigation Area (ORIA) in Western Australia.

51. Land used by the Project must meet the requirements set out in the Consultant Forester's report at section 8 of the IM.

52. Sufficient water is available for the Project from the Ord River Irrigation Scheme. The Project Plantation will be irrigated for the full term of the Project.

Constitution

53. The Constitution establishes the Project and operates as a deed binding all Participants and Kimberley Timber Corporation Ltd. The Constitution sets out the terms and conditions under which Kimberley Timber Corporation agrees to act as Forestry Manager. Upon acceptance into the Project, Participants are bound by the Constitution by virtue of their participation in the Project.

54. In order to acquire an interest in the Project, an entity must make an Application through Primary Securities Ltd who accepts the applications on behalf of the Forestry Manager. Among other things, the Application is to be completed using the approved form, signed by or on behalf of Applicant, lodged at the registered office of Primary Securities Ltd and accompanied by payment of the Initial Contribution (clause 3.3).

55. Upon the Application being accepted, the Applicant is deemed to have become a party to the Constitution and the Forestry Management Agreement (clause 3.4) and is allotted two or more Forestry Interests. Upon Allotment of the Forestry Interests the Initial Contribution may be applied as the Initial Contribution payable under the Forestry Management Agreement (clause 5.1).

56. In summary, the Constitution also sets out provisions relating to:

- the Forestry Manager's powers and responsibilities;
- the receipt of further contributions from participants;
- period and termination of the Project; and
- procedures for handling complaints and disputes.

Lease and Sub-Lease

57. KTC Landbank Ltd (Land Company) will enter into a Lease(s) with the land owner in respect of the Project land. The Land Company will then enter into a Sub-Lease(s) with the Forestry Manager so that this land can be used for the purposes of the Project.

58. The Forestry Manager must use the Land only for the purpose of growing trees.

59. Under the Sub-Lease, the Land Company grants the Forestry Manager a lease as Bare Trustee. The Sub-Lease includes:

- a profit a prendre entitling the Forestry Manager on behalf of the Participants to Establish, Tend and Fell Trees on the Plantation;

- all right title and interest in the Timber from the Trees on the Land; and
- the non-exclusive right of access to the Land (clause 2.1 of the Sub-Lease).

60. The Land Company also grants to the Forestry Manager the non-exclusive right to use the Irrigation System, the licence/rights to draw water for the requirements of the Plantation and all infrastructure, plant and equipment for the purpose of enjoying these rights.

61. The Forestry Manager will pay the Lease Fee in the amount and manner as set out in Part 4 of the Schedule to the Sub-Lease.

Forestry Management Agreement

62. Under the Forestry Management Agreement between the Forestry Manager and each Participant, the Participant engages the Forestry Manager, as an independent contractor to operate the Project in accordance with such obligations, rights and powers as are set out in the Agreement. This includes the performance of Direct Forestry Services, the Marketing of the Timber and the receipt of Gross Harvest Proceeds.

63. The Direct Forestry Services include, amongst other things:

- selecting the Land and other pre-establishment activities;
- preparing the site (including clearing, deep ripping and mounding, fertilising, weed control, irrigation, and creating fire breaks);
- planting such number of Trees in accordance with the Forestry Management Plan so that by 31 December 2009 there is an average of no less than 500 Trees per hectare on the plantable area;
- ensuring that the Trees receive adequate water as may be necessary;
- tending the Trees as required under the Forestry Management Plan; and
- felling the Trees in accordance with sound forestry practice.

64. The Forestry Manager or Forestry Contractor, if appointed, will sell the Timber harvested from the Plantation.

65. The Forestry Manager will provide to Participants a report on or about 30 September following establishment of the Plantation and annually thereafter on or about 30 September each year. The Forestry Manager will also provide a report within 60 days after the sale of any Timber setting out details of the sale and any costs associated with the sale.

Forestry Contract

66. Under the Forestry Contract between the Forestry Manager and KTC Plantation Management Pty Ltd as Forestry Contractor, the Forestry Manager engages the Forestry Contractor, as an independent contractor to carry out, supervise and monitor the management and conduct of the Plantation and Direct Forestry Services for and on behalf of the Forestry Manager.

67. The Forestry Contractor will ensure that at all times public risk insurance and such additional insurance as the Forestry Manager and the Forestry Contractor agree as normal and reasonable in the forestry industry is taken out with a reputable insurer.

68. In consideration of the performance of the Forestry Contractor of its duties and obligations as set out in the Agreement, the Forestry Manager agrees to pay to the Forestry Contractor the Contributions and other money received from the Participants as and when required according to the cash flows of the Project.

Pooling of Timber and Entitlement to Net Proceeds

69. The Constitution and the Forestry Management Agreement set out provisions relating to the Participant's entitlement to harvest proceeds.

70. The Forestry Manager will pool all Timber from the Plantation for sale and will (or appoint the Forestry Contractor on behalf of the Forestry Manager to) market and sell the harvested Timber at the highest price practicable.

71. The Forestry Manager shall receive the Gross Harvest Proceeds and will within 2 months of receipt, distribute the Prescribed Proportion of Receipts to the Participant after deducting any money owed by the Participant to the Forestry Manager under the Constitution and the Forestry Management Agreement.

72. The term 'Prescribed Proportion' is defined in the Constitution at clause 1.

Fees

73. Under Part 2 of the Schedule to the Forestry Management Agreement a Participant will make payments as described below on a per 'Forestry Interest' basis:

- **Initial Contribution** of $7,500 payable on application for the costs of Establishment and Tending the Trees from Year 1 to Year 4;
- **Deferred Contribution** of 5.5% of Gross Harvest Proceeds from the sale of Timber from the Trees for Tending Costs for Year 5 to Year 10, payable at Year 10;

- **Felling Costs** of 20.9% of Gross Harvest Proceeds from the sale of Timber from the Trees, payable at Year 10;
- **Marketing Costs** of 8.8% of Gross Harvest Proceeds from the sale of Timber from the Trees, payable at Year 10;
- **Performance Bonus** equal to 27.5% of that proportion of Gross Harvest Proceeds relating to the excess over 0.45 cubic metres per log; and
- **Extraordinary Event Contribution** for Tending Trees until Felling (if no other funds are available) or for remedying damage caused to Trees (if reasonable).

Finance

74. To finance all or part of the cost of their 'Forestry Interest' a Participant may borrow from an independent lender external to the Project.

75. A Participant who enters into a finance arrangement with an independent lender external to the Project may request a private ruling on the deductibility or otherwise of interest incurred under finance arrangements not covered by this Product Ruling.

76. This Product Ruling does not apply if a Participant enters into an agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' will be granted to the borrowers for the purpose of section 82KL of the ITAA 1936, or the funding arrangements transform the Project into a 'scheme' to which Part IVA of the ITAA 1936 may apply;
- the loan terms are of a non-arm's length nature;
- repayments of the principal and 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) back to the lender or any associate;
- 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 for the Project.

Commissioner of Taxation
11 June 2008

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Structure of the Project

77. In return for payment of the Initial Contribution and the other fees and expenses, required under the Project Agreements during the term of the Project, Participants will hold a 'Forestry Interest' in a 'forestry managed investment scheme'. The Project qualifies as a 'forestry managed investment scheme' because its purpose is for 'establishing and tending trees for felling in Australia' (see subsection 394-15(1)).

78. Under the Constitution of the Project and the other supporting agreements, the holding of a 'Forestry Interest' in the Project gives each Participant a right to a share in the proceeds of the harvest of the trees grown on the Project land. That share of proceeds is determined using the number of 'Forestry Interests' held by a Participant as a proportion of all 'Forestry Interests' held by 'Participants'[6] in the Project.

Is the Participant carrying on a business?

79. Two Taxation Rulings are relevant in determining whether a Participant will be carrying on a business of primary production.

80. The general indicators used by the Courts are set out in Taxation Ruling TR 97/11 Income tax: am I carrying on a business of primary production?

81. Taxation Ruling TR 2000/8 Income tax: investment schemes, particularly paragraph 89, is more specific to arrangements such as the KTC Mahogany Project 2008. As Taxation Ruling TR 2000/8 sets out, the relevant principles have been established in court decisions such as *Commissioner of Taxation v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55.

82. Having applied these principles to the forestry managed investment scheme set out above, a Participant in the KTC Mahogany Project 2008 is not considered to be carrying on a business of forestry.

Allowable deductions

Sections 8-5, 12-5, 394-10 and 394-20

83. Section 8-5 allows certain specific deductions to be claimed against the assessable income of a taxpayer. The list of specific deductions is shown in a table in section 12-5 and includes payments under a 'forestry managed investment scheme' that meet the requirements of subsection 394-10(1).

[6] The term 'participant' is defined in subsection 394-15(4).

84. The amounts are allowable deductions in the income year in which they are paid (subsection 394-10(2)).

85. Where a Participant does not fully pay an amount, or the amount is not fully paid on their behalf in an income year (see section 394-20), it is deductible only to the extent to which it has been paid. The unpaid balance is then deductible in the income year or income years in which it is actually paid. This may occur, for example, if all or part of the amount is borrowed and the financier fails to transfer the funds to the account of the 'forestry manager' by 30 June in an income year.

The '70% DFE rule'

Paragraph 394-10(1)(c) and section 394-35

86. The threshold test for Participants in the Project to be entitled to deductions under subsection 394-10(1) is the '70% DFE rule' in paragraph 394-10(1)(c). Under that rule it must be reasonable to expect that on 30 June 2008, the amount of 'direct forestry expenditure'[7] under the scheme will be no less than 70% of the amount of payments under the scheme.[8]

87. The amount of all 'direct forestry expenditure' is the amount of the net present value of all 'direct forestry expenditure' that the 'Forestry Manager'[9] of the Project, has paid or will pay under the scheme (subsection 394-35(2)).

88. The 'amount of payments under the scheme' is the amount of the net present value of all amounts (that is the fees and expenses) that all current and future 'Participants' in the scheme have paid or will pay under the scheme (subsection 394-35(3)).

89. Both of the above amounts are determined as at 30 June 2008 taking into account:

- the timing requirements in subsections 394-35(4) and (5);
- any amounts that can reasonably be expected to be recouped (subsection 394-35(6));
- the discount rate in subsection 394-35(7); and
- the market value rule in subsection 394-35(8).

90. Applying all of these requirements to the information provided by the Forestry Manager of the Project, the Commissioner has determined that the Project will satisfy the '70% DFE rule' on 30 June 2008.

[7] See section 394-45.
[8] See subsection 394-35(1) and section 394-40.
[9] Defined in section 394-15(2).

The other elements for deductibility under subsection 394-10(1)

91. The requirement of paragraph 394-10(1)(d) that Participants in the Project not have day to day control over the operation of the Project (despite having a right to be consulted or give directions) is clear from the Project Agreements as are the alternative elements of paragraph 394-10(1)(e) relating to the number of Participants in the scheme and the Forestry Manager's role in other managed investment schemes.

92. The final requirement for deductibility requires all the Project trees to be established within 18 months of 30 June 2008 (see paragraph 394-10(1)(f) and subsection 394-10(4)). The planting timeline provided with the application for this Product Ruling by the Forestry Manager indicates that all the trees required to be established under the scheme will be planted on the Project land by 31 December 2009.

93. Accordingly, subject to the qualifications set out below, amounts paid by Participants to the Forestry Manager in relation to their 'Forestry Interests' satisfy all requirements of subsection 394-10(1).

Loss of deductions previously allowed under section 394-10(1)

94. Two situations may lead to a loss of deductions previously allowed to Participants.

95. The first of these situations will occur if the Forestry Manager fails to establish the trees on the Project land within 18 months. Where this occurs the Forestry Manager is required to notify the Commissioner within 3 months of the end of the 18 month period (section 394-10 of Schedule 1 to the TAA).

96. The second situation where a Participant may have deductions disallowed is where a 'CGT event' happens to their 'Forestry Interest' within 4 years from 30 June of the income year they paid an amount under the scheme, for example, the Initial Contribution (see subsection 394-10(5)).

97. For the purposes of this provision, the Commissioner is able to amend the assessment of a Participant within 2 years of the relevant 'CGT event' happening. The Commissioner's power to amend in these circumstances applies despite section 170 of the ITAA 1936 (subsection 394-10(6) of the ITAA 1997).

98. Where a 'CGT event' happens to the 'Forestry Interest' of a Participant within 4 years, the market value of the 'Forestry Interest' at the time of the 'CGT event' or the decrease in the market value of the 'Forestry Interest' as a result of the 'CGT event' is still included in the assessable income of the Participant by section 394-25. The amount must be included in assessable income even where an amendment has disallowed or may disallow the deductions previously allowed under section 394-10.

Prepayment provisions

Sections 82KZL to 82KZMF

99. 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 that will not be wholly done within the same year of income as the income year in which the expenditure is incurred. For schemes such as this Project, the main operative provisions are sections 82KZMD and 82KZMF of the ITAA 1936.

100. However, subsection 394-10(7) of the ITAA 1997 specifically provides that sections 82KZMD and section 82KZMF of the ITAA 1936 do not affect the timing of amounts deductible under section 394-10 of the ITAA 1997. Accordingly, the prepayment provisions in sections 82KZME and 82KZMF of the ITAA 1936 have no application to this scheme.

Assessable income, 'CGT events' and the 'Forestry Interests' of Participants who are 'initial participants'

Sections 6-10, 10-5 and 394-25

101. Section 6-10 includes in assessable income amounts that are not ordinary income. These amounts, called statutory income, are listed in the table in section 10-5 and include amounts that are included in the assessable income of 'initial participants' of a 'forestry managed investment scheme' by subsection 394-25(2).

Subsection 394-25(2)

102. Where a 'CGT event' (other than for a 'CGT event' in respect of a thinning)[10] happens to a 'Forestry Interest' held by a Participant in this Project, subsection 394-25(2) includes an amount in the assessable income of the Participant if:

- the Participant can deduct or has deducted an amount under section 394-10; or
- the Participant would have met the condition immediately above if subsection 394-10(5) had not applied to disallow the deduction(s). Paragraphs 30 to 32 and paragraphs 96 to 98 of this Ruling explain when deductions will be disallowed under subsection 394-10(5).

[10] A thinning under this scheme is not a 'CGT event'.

Market value rule applies to' CGT events'

103. If, as a result of the 'CGT event' the Participant either:

- no longer holds the 'Forestry Interest'; or
- otherwise – where the Participant continues to hold the 'Forestry Interest', but there is a decrease in the market value of the 'Forestry Interest';

then the market value of the 'Forestry Interest' at the time of the event, or the reduction of the market value of the 'Forestry Interest' as a result of the event, is included in the assessable income of the Participant in the income year in which the 'CGT event' happens (subsection 394-25(2)). A market value rule applies rather than the amount of money actually received from the 'CGT event' (subsection 394-25(3)). However, the market value and the actual amount of money received may be the same.

104. The market value amount included in the assessable income of a Participant is the value of the 'Forestry Interest' just before the 'CGT event', or where the Participant continues to hold their interest after the event, the amount by which the market value of the 'Forestry Interest' is reduced as a result of the 'CGT event' (subsection 394-25(2)).

105. Section 394-25 will apply where the 'Forestry Interest' is sold, is extinguished, or ceases, and will include 'CGT events' such as a full or partial sale of the 'Forestry Interest' or from a full or partial clear-fell harvest of the trees grown under the Project.

Division 35 – deferral of losses from non-commercial business activities and the Commissioner's discretion

106. Division 35 has no application to losses arising from the Participant's participation in the Project, as a Participant who is an 'initial participant' in the Project is not carrying on a business activity (see paragraphs 23 and 79 to 82 of this Ruling).

Section 82KL – recouped expenditure

107. The operation of section 82KL of the ITAA 1936 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 of the ITAA 1997.

Part IVA – general tax avoidance provisions

108. For Part IVA of the ITAA 1936 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).

109. The KTC Mahogany Project 2008 will be a ‘scheme’ and a Participant will obtain a ‘tax benefit’ from entering into the ‘scheme’, in the form of tax deductions for the amounts detailed at paragraph 27 of this Ruling that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

110. Participants to whom this Product Ruling applies will derive assessable income from holding or disposing of their ‘Forestry Interest’ in the Project. There are no facts that would suggest that Participants have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Product Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing at arm’s length or, if any parties are not dealing at arm’s length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) of the ITAA 1936 it cannot be concluded, on the information available, that Participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Appendix 2 – Detailed contents list

111. The following is a detailed contents list for this Product Ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/11; TR 98/22; TR 2000/8

Subject references:

- carrying on a business
- direct forestry expenditure
- DFE
- interest expenses
- forestry MIS
- forestry interest
- managed investment schemes
- market value substitution rule
- payments under the scheme
- producing assessable income
- product rulings
- reasonable expectation
- tax avoidance
- taxation administration
- 4 year holding period
- 70 per cent DFE rule

Legislative references:

- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZLA
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZME
- ITAA 1936 82KZMF
- ITAA 1936 Pt IVA
- ITAA 1936 170
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1997 6-10
- ITAA 1997 8-1
- ITAA 1997 8-5
- ITAA 1997 10-5
- ITAA 1997 12-5
- ITAA 1997 Subdiv 27-A
- ITAA 1997 Div 35
- ITAA 1997 Div 394
- ITAA 1997 394-10
- ITAA 1997 394-10(1)
- ITAA 1997 394-10(1)(c)
- ITAA 1997 394-10(1)(d)
- ITAA 1997 394-10(1)(e)
- ITAA 1997 394-10(1)(f)
- ITAA 1997 394-10(2)
- ITAA 1997 394-10(4)
- ITAA 1997 394-10(5)
- ITAA 1997 394-10(6)
- ITAA 1997 394-10(7)
- ITAA 1997 394-15(1)
- ITAA 1997 394-15(2)
- ITAA 1997 394-15(4)
- ITAA 1997 394-15(5)
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- ITAA 1997 394-30
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- ITAA 1997 394-35(1)
- ITAA 1997 394-35(2)
- ITAA 1997 394-35(3)
- ITAA 1997 394-35(4)
- ITAA 1997 394-35(5)
- ITAA 1997 394-35(6)
- ITAA 1997 394-35(7)
- ITAA 1997 394-35(8)
- ITAA 1997 394-40
- ITAA 1997 394-45
- ITAA 1997 995-1
- TAA 1953
- TAA 1953 Sch 1 357-75(1)
- TAA 1953 Sch 1 394-10
- SISA 1993
- Copyright Act 1968
- Corporations Act 2001
- Corporations Act 2001 761G

Case references:

- Commissioner of Taxation v. Lau (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55

ATO references

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