



PR 2009/17 - Income tax: KTC Mahogany Project 2009

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Product Ruling

Income tax: KTC Mahogany Project 2009

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! 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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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 Commissioner **does not** sanction or guarantee this product. Further, the Commissioner gives 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. The Commissioner recommends 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 Ruling relates. In this Product Ruling this scheme is referred to as the KTC Mahogany Project 2009, or simply as 'the Project'.
2. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated. Where used in this Ruling, the word 'associate' has the meaning given in section 318 of the *Income Tax Assessment Act 1936* (ITAA 1936). In this Ruling, terms defined in the Project agreements have been capitalised.

Class of entities

3. 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.
4. 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'.
5. 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.
6. A Participant will have executed the relevant Project Agreements set out in paragraph 36 of this Ruling on or before 30 June 2009 and will hold a 'forestry interest' in the Project.
7. The class of entities who can rely on this Product Ruling does **not** include Participants who:
 - are accepted into this Project before the date of this Ruling;
 - participate in the scheme through offers made other than through the Product Disclosure Statement; or
 - enter into finance arrangements with entities associated with the Project.

Superannuation Industry (Supervision) Act 1993

8. 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

9. 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 36 to 75 of this Ruling.

10. 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

12. This Product Ruling applies prospectively from 22 April 2009, the date this Product Ruling is made. It therefore applies only to the specified class of entities that enter into the scheme from 22 April 2009 until 30 June 2009, 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.

13. However this Product Ruling only applies to the extent that there is no change in the scheme or in the entity's involvement in the scheme.

Changes in the law

14. 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.

15. 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

16. 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

17. All amounts and percentages referred to in this Product Ruling exclude the Goods and Services Tax (GST), unless otherwise specified. The transactions in respect of this scheme may, where appropriate, have GST implications. Those GST implications are outside the scope of this Product Ruling.

Ruling

Structure of the Project

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

19. 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 4 to 7 of this Ruling) who is accepted to participate in the 'forestry managed investment scheme' described below at paragraphs 36 to 75 of this Ruling on or after 22 April 2009 and on or before 30 June 2009.

¹ See subsection 394-15(5).

20. 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

21. A Participant (as described in paragraphs 4 to 7 of this Ruling) 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

Section 394-35 and subsection 394-10(4)

22. The taxation obligations and benefits set out below have been determined using the information provided to the Commissioner by KTC Securities Ltd, the Responsible Entity for the Project. On the basis of that information the Commissioner has decided that on 30 June 2009 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'.

23. The Ruling will only apply if the Responsible Entity 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 2010.

24. 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 1,000 Trees per hectare. The Responsible Entity 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 2010.

Allowable deductions

Sections 8-5, 394-10, 394-20 and Division 27

25. A Participant in the Project can claim deductions for the amounts shown in the Table below that are paid to the Responsible Entity (sections 8-5 and 394-10).

² See section 394-30.

³ The '70% DFE rule' is set out in section 394-35.

⁴ See subsection 394-10(4).

26. The deductibility of these amounts remains subject to a requirement that a CGT event⁵ does not happen in relation to the Participant's 'forestry interest' before 1 July 2013 (see paragraphs 29 to 31 of this Ruling).

27. The amount is deductible in the income year in which it is paid, or is 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 year or years in which it is actually paid.

28. Amounts that are allowable deductions under Division 394 cannot also be claimed as deductions under section 8-1 (section 8-10).

Fee	Amount	Year(s) deductible
Initial Contribution	\$6,820	2009
Deferred Contribution	5.63% of Gross Harvest Proceeds	The year in which this amount is paid See Note (i)
Felling Costs	19.42% of Gross Harvest Proceeds	The year in which this amount is paid See Note (i)
Marketing costs	8.32% of Gross Harvest Proceeds	The year in which this amount is paid See Note (i)
Performance Bonus	See Note (ii)	The year in which this amount is paid See Note (i)

Notes:

- (i) Participants will be notified by the Responsible Entity of the year in which these amounts are paid. Harvest is expected to occur in 2019.
- (ii) The Performance Bonus is payable out of Gross Harvest Proceeds, depending on yield. It is defined as 25% of that proportion of the Net Proceeds of Sale as the amount by which the average yield for the logs felled in the relevant Felling exceeds 0.45 cubic metres.

⁵ Defined in section 995-1.

‘CGT event’ within 4 years for Participants who are ‘initial participants’***Subsections 394-10(5) and (6)***

29. Deductions for the Initial Contribution are not allowable where a ‘CGT event’ happens in relation to the ‘forestry interest’ of a Participant before 1 July 2013 (subsection 394-10(5)).

30. Where deductions for these amounts have 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 ITAA 1936.

31. 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’.

Assessable income, ‘CGT events’ and the ‘forestry interests’ of Participants who are ‘initial participants’***Sections 6-10, 17-5, and 394-25***

32. 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), less any GST payable on those proceeds (section 17-5).

33. 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)).

34. ‘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 sections 82KZM, 82KZME, 82KZMF, 82KL and Part IVA of the ITAA 1936

35. Where a Participant is accepted to participate in the Project set out at paragraphs 36 to 75 of this Ruling, the following provisions of the ITAA 1936 or the ITAA 1997 have application as indicated:

- losses arising from participation in the Project are not within the scope of Division 35;
- 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.

Scheme

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

- Application for a Product Ruling as constituted by documents, correspondence and emails provided on 12 and 18 November 2008, 4 and 9 December 2008, 9 February 2009, 10 March 2009 and 1, 3, 6, 7, 16 and 17 April 2009;
- Draft Product Disclosure Statement for the Project, received 16 April 2009;
- Draft **Constitution** for the Project between the Responsible Entity and Each Several Participant received 3 April 2009;
- Draft Compliance Plan for the Project received 3 April 2008;
- Draft **Forestry Management Agreement** for the Project between Each Several Participant and the Responsible Entity received 3 April 2009;
- Draft Forestry Contract for the Project between the Responsible Entity and KTC Plantation Management Pty Ltd received 3 April 2009;
- Draft Sub-Lease to RE for Lot 1 on Plan 22335 between KTC Landbank Pty Ltd and the Responsible Entity received 9 February 2009;
- Draft Sub-Lease to RE for Lot 3 on Plan 22335 between KTC Landbank Pty Ltd and the Responsible Entity received 9 February 2009;

- Draft Sub-Lease of Lot 1 on Plan 22335 between Kimberley Timber Corporation Limited and KTC Landbank Pty Ltd received 9 February 2009;
- Draft Sub-Lease of Lot 3 on Plan 22335 between Kimberley Timber Corporation Limited and KTC Landbank Pty Ltd received 12 November 2009;
- Draft Forestry Management Plan for the Project received 12 November 2008;
- Draft Rules for the Project received 9 February 2009.

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

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

38. The documents highlighted are those that a Participant may enter into. For the purposes of describing the scheme to which this 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.

Overview

39. The main features of the Project are as follows:

Location	Ord River Irrigation Area Western Australia or, if more than 500 Forestry Interests are subscribed for, the Tinaroo Irrigation Area Queensland
Species of trees to be planted under the scheme	African Mahogany (<i>Khaya senegalensis</i>)
Term of the Project	Approximately 10 years
Date all trees must be planted on scheme land	31 December 2010
Number of trees per hectare	Approximately 1,000
Number of hectares offered for cultivation	Up to 1,000 hectares
Size of each 'forestry interest'	Equivalent of 0.25 hectares
Minimum allocation of 'forestry interests' per Participant	Two
Minimum subscription	None

Initial cost	\$6,820
Other costs	<ul style="list-style-type: none"> • Deferred Contribution • Felling Costs • Marketing Costs • Performance Bonus All payable out of Gross Harvest Proceeds

40. The Project will be a registered managed investment scheme under the *Corporations Act 2001*. KTC Securities Ltd has been issued with an Australian Financial Service Licence No. 323852 and will be the Responsible Entity for the Project.

41. The Project will involve the establishment, tending, felling and harvesting of African mahogany (*Kyaha senegalensis*) trees for the purpose of selling the Timber.

42. An offer to participate in the Project will be made through a Product Disclosure Statement (PDS). The offer under the PDS is for up to a maximum of 4,000 'forestry interests' in the Project, which corresponds to 1,000 hectares.

43. An entity that participates in the Project as a Participant will do so by acquiring a minimum of two Forestry Interests in the Project on or before 30 June 2009, each equating to 0.25 hectares in size.

44. Under the terms of the Application Form contained in the PDS, Applicants agree to be bound by the Constitution and the Rules as a Participant, offers to enter into the Forestry Management Agreement as a Participant, and acknowledges that upon the application being accepted, the applicant will be bound by the Forestry Management Agreement as a Participant.

45. For the purposes of this Product Ruling, Applicants who are accepted to participate in the Project and who become a party to the Forestry Management Agreement on or before 30 June 2009 will become Participants in the Project.

46. Under the terms of the PDS, the Forestry Interests will be issued on acceptance of the applications.

47. The Responsible Entity will lease land for the Project in the Ord River Irrigation Area in Western Australia. However, if subscriptions for the project exceed 500 Forestry Interests, the Responsible Entity will conduct the Project in Queensland and will lease land in the Tinaroo Irrigation Area.

48. Land used by the Project must be approved by the Forestry Expert as being suitable for planting and growing mahogany.

49. Sufficient water is available for the Project from the Ord River Irrigation Scheme or the Tinaroo Irrigation Scheme.

Constitution

50. The Constitution establishes the Project and operates as a deed binding all Participants and KTC Securities Ltd. The Constitution sets out the terms and conditions under which KTC Securities Ltd agrees to act as Responsible Entity and thereby manage the Project. Upon acceptance into the Project, Participants are bound by the Constitution by virtue of their participation in the Project.

51. In order to acquire an interest in the Project, an entity must make an application to KTC Securities Ltd, as Responsible Entity. Among other things, the application is to be completed using the approved form, signed by or on behalf of the Applicant, delivered to the Responsible Entity or its authorised agent and accompanied by payment of the Initial Contribution.

52. Upon the Application being accepted, the Applicant is deemed to have become a party to the Constitution and the Forestry Management Agreement 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.

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

- The Responsible Entity's powers and responsibilities;
- The receipt of further contributions from Participants;
- The period and termination of the Project; and
- Procedures for handling complaints and disputes.

Compliance Plan

54. As required by the *Corporations Act 2001*, KTC Securities Ltd has prepared a Compliance Plan. The purpose of the Compliance Plan is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Participants are protected.

Lease and Sub-lease

55. The arrangements and terms of the lease agreements for the project land in either Western Australia or Queensland will be as set out in paragraphs 56 to 60.

56. Kimberley Timber Corporation Limited will either purchase or lease the project land. It will enter into a lease(s) or sub-lease agreement with KTC Landbank Ltd (Land Company) in respect of the Land. The Land Company will then enter into a sub-lease agreement or agreements with the Responsible Entity (the Sub-Lease to RE) so that the land can be used for the purposes of the Project.

57. Under the terms of the Sub-Lease to RE, the Responsible Entity must use the Land only for the purpose of growing African mahogany trees.

58. The Sub-Lease to RE includes:

- a profit a prendre entitling the Responsible Entity 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.

59. Under the terms of the Sub-Lease to RE the Land Company also:

- grants to the Responsible Entity the non-exclusive right to use the Irrigation System, the licence or rights to draw water for the requirements of the Plantation and all infrastructure, plant and equipment for the purpose of enjoying these rights; and
- enters into a covenant to ensure that at all times there is a sufficient water allocation for the Plantation.

60. The Responsible Entity will pay the Lease Fee in the amount and manner as set out in the Schedule to the Sub-Lease to RE.

Forestry Management Agreement

61. Under the Forestry Management Agreement between the Responsible Entity and each Participant, the Participant engages the Responsible Entity 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 the purchase price or net purchase price.

62. The services to be carried out 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 2010 there is an average of no less than 1,000 Trees per hectare on the plantable area;
- Tending the Trees; and
- Felling the Trees in accordance with sound forestry practice.

63. The Responsible Entity, or Forestry Contractor, if appointed, will sell the Timber harvested from the Plantation.

64. The Responsible Entity will provide to Participants a report by 30 September in the year after Allotment, and on 30 September of each succeeding year, setting out matters relating to the state of the Plantation, work carried out and progress. The Responsible Entity 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

65. Under the Forestry Contract between the Responsible Entity and KTC Plantation Management Pty Ltd as Forestry Contractor, the Responsible Entity 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 Responsible Entity.

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

67. In consideration of the performance of the Forestry Contractor of its duties and obligations as set out in the Forestry Contract, the Responsible Entity 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

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

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

70. The Responsible Entity shall receive the purchase price or net purchase price from the sale of the timber and will, within two months of receipt, distribute the Prescribed Proportion of Receipts to the Participant after deducting any money owed by the Participant to the Responsible Entity under the Constitution and the Forestry Management Agreement.

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

Fees

72. 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:

- an **Initial Contribution** of \$6,820 payable on application for the costs of Establishment and Tending the trees from Year 1 to Year 4;
- a **Deferred Contribution** of 5.63% of Gross Harvest Proceeds from the sale of Timber from the Trees for Tending costs for Year 5 to Year 10, payable out of Gross Harvest Proceeds;
- **Felling Costs** of 19.42% of Gross Harvest Proceeds for Felling the Trees, payable out of Gross Harvest Proceeds;
- **Marketing Costs** of 8.32% of Gross Harvest Proceeds, payable out of Gross Harvest Proceeds;
- a **Performance Bonus** equal to 25% of that proportion of Net Proceeds of Sale as the amount by which the average yield for the logs felled in the relevant Felling exceeds 0.45 cubic metres; and
- an **Extraordinary Event Contribution** for Tending the Trees until Felling (if no other funds are available) or for remedying damage caused to Trees (if appropriate).

Finance

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

74. 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.

75. This Product Ruling does not apply if the finance arrangement entered into by the Participant 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 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 or rate of interest are 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 Participants for the Project.

Commissioner of Taxation22 April 2009

Appendix 1 – Explanation

❶ *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

76. 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))

77. 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?

78. The general indicators used by the Courts in determining whether an entity is carrying on a business are set out in Taxation Ruling TR 97/11 Income tax: am I carrying on a business?

79. More recently, and in relation to a managed investment scheme similar to that which is the subject of this Ruling, the Full Federal Court in *Hance v. FC of T; Hannebery v. FC of T* [2008] FCAFC 196; 2008 ATC 20-085 applied these principles to conclude that 'Participants' in that scheme were carrying on a business of producing almonds (at FCAFC 90; ATC 90).

80. Application of these principles to the arrangement set out above leads to the conclusion that a Participant (as described in paragraphs 4 to 7), in the Project is not considered to be carrying on a business of primary production involving afforestation activities.

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

Allowable deductions***Sections 8-5, 12-5, 394-10 and 394-20***

81. 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).

The '70% DFE rule'***Paragraph 394-10(1)(c) and section 394-35***

82. 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 2009, 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

83. The amount of all 'direct forestry expenditure' is the amount of the net present value of all 'direct forestry expenditure' that the Responsible Entity, as 'forestry manager'⁹ of the Project, has paid or will pay under the scheme (subsection 394-35(2)).

84. The 'amount of payments under the scheme' is the amount of the net present value of all amounts (i.e., 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)).

85. Both of the above amounts are determined as at 30 June 2009 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).

86. Applying all of these requirements to the information provided by the Responsible Entity of the Project, the Commissioner has determined that the Project will satisfy the '70% DFE rule' on 30 June 2009.

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)

87. 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 is clear from the Project Agreements as is the alternative element of paragraph 394-10(1)(e) relating to the number of Participants in the scheme.

88. The final requirement for deductibility requires all the Project trees to be established within 18 months of 30 June 2009 (see paragraph 394-10(1)(f) and subsection 394-10(4)). The planting timeline provided with the application for this Ruling by the Responsible Entity indicates that all the trees required to be established under the scheme will be planted on the Project land by 31 December 2010.

89. Accordingly, subject to the qualifications set out below, amounts paid by Participants to the Responsible Entity in relation to their 'forestry interests' satisfy all requirements of subsection 394-10(1).

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

91. Amounts that are allowable deductions under Division 394 cannot also be claimed as deductions under section 8-1 (section 8-10).

92. 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 year or 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' on or before 30 June in an income year.

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

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

94. The first of these situations will occur if the Responsible Entity fails to establish the Trees on the Project Land within 18 months. Where this occurs the Responsible Entity 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).

95. 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)).

96. 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)).

97. 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

98. 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 year in which the expenditure is incurred. For schemes such as this Project, the main operative provisions are sections 82KZMD and section 82KZMF of the ITAA 1936.

99. However, subsection 394-10(7) specifically provides that sections 82KZMD and section 82KZMF of the ITAA 1936 do not affect the timing of amounts deductible under section 394-10.

100. Accordingly, the prepayment provisions 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 29 to 31 and paragraphs 95 to 97 of this Ruling explain when deductions will be disallowed under subsection 394-10(5).

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.

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

Section 8-1 – interest on loans to finance the ‘forestry interest’ of a Participant

106. Participants who borrow to fund their investment in the Project may be entitled to claim deductions for interest incurred in respect of the loan. These Participants may apply for a private ruling on the deductibility of loan interest or may self assess the deductibility of the interest.

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 of the ITAA 1936. It will not apply to deny the deduction otherwise allowable under section 8-1.

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 2009 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 28 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 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 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.

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/11; TR 98/22

Subject references:

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

Legislative references:

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- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZLA
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