
General outline and financial impact

Forestry managed investment schemes

Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936) to protect the deductions of investors in forestry managed investment schemes (MIS) where the four year holding period rules are failed for reasons genuinely outside the investor's control.

This schedule also amends the *Taxation Administration Act 1953* (TAA 1953) to maintain the capacity of the Commissioner of Taxation to apply for civil penalties against the promoters of affected schemes, notwithstanding the amendments to the four year rules.

Date of effect: The amendments apply to CGT events happening on or after 1 July 2007.

Proposal announced: This measure was announced in the Assistant Treasurer's Media Release No. 074 of 21 October 2009.

Financial impact: This measure has the following revenue implications:

<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
..

Compliance cost impact: This measure is expected to have a low impact on compliance costs.

Chapter #

Forestry managed investment schemes

Outline of chapter

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1.2 This schedule also amends the *Taxation Administration Act 1953* (TAA 1953) to maintain the capacity of the Commissioner of Taxation to apply for civil penalties against the promoters of affected schemes, notwithstanding the amendments to the four year rules.

Context of amendments

1.3 Investors in forestry MIS can claim an immediate tax deduction for expenditure incurred in the scheme, subject to certain conditions.

1.4 Division 394 of ITAA 1997 covers schemes for which amounts are paid by investors on or after 1 July 2007, while section 82KZMG of ITAA 1936, in conjunction with section 8-1 of ITAA 1997, applies to schemes for which expenditure is incurred by investors on or after 1 July 2001 and on or before 30 June 2008.

1.5 During the overlapping period, deductions for investors in forestry MIS might have been claimed under either Division 394 or section 8-1 of ITAA 1997.

Holding period rules

1.6 In order for an initial investor in a forestry MIS to claim a deduction under Division 394 of ITAA 1997, the law requires that a CGT event does not happen in relation to the investor's forestry interest within four years after the end of the income year in which an amount is first incurred by the investor.

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1.7 This is called the ‘four year rule’ as it has the effect of requiring the initial investor to hold their forestry interest for four years. The minimum holding rule period is an integrity measure designed to prevent taxpayers from disposing of their interest shortly after claiming their upfront tax deduction.

1.8 If this condition is failed, the taxpayer’s assessment may be amended to disallow the deduction. The Australian Taxation Office’s (ATO) interpretation of the law is that the Commissioner has no discretion to allow a deduction claimed under Division 394 in these circumstances, even where the reason for the CGT event happening is outside the taxpayer’s control.

1.9 However, if the taxpayer is carrying on a business, they may be entitled to a deduction under section 8-1 of ITAA 1997.

1.10 Initial investors who can claim a deduction under section 8-1 and who satisfy section 82KZMG of ITAA 1936 are subject to a similar four year rule under section 82KZMGA. If the conditions are failed, section 82KZMGA denies a deduction outright.

1.11 Unlike investors in schemes subject to Division 394, the ATO considers that these taxpayers do not have a fall-back position. This is because section 82KZMGA denies a deduction outright if the conditions are failed.

1.12 A CGT event (which would cause an investor to fail the four year rule) may happen for many different reasons. Examples of such reasons include the sale or transfer of the interest by the investor, the transfer of the interest as a result of the investor’s death or the winding-up or restructure of the MIS.

1.13 The Government has decided to amend the tax law to protect the deductions of investors in forestry MIS from being clawed back for reasons genuinely outside of the investor’s control. For further information refer to the Assistant Treasurer’s Media Release No. 074 of 21 October 2009.

Promoter penalties

1.14 Subdivision 290-B of TAA 1953 contains the promoter penalties provisions, which are designed to discourage the implementation of schemes covered by a product ruling in a way that is materially different from the product ruling.

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1.15 Currently, the Commissioner may apply to the Federal Court for penalties against the promoter if the scheme is implemented in a way that is materially different from that described in the product ruling.

1.16 The concept of material difference is very wide in that it covers conduct because of which any tax outcome is capable or likely to be different from that provided for in a product ruling, including future tax outcomes affected by conduct that is beyond an investor's control.

1.17 Despite this, it may be possible that the amendments to the four year rule, without a corresponding amendment to the promoter penalty provisions, would mean there would be no material difference from that described in a product ruling. That is, there is a risk that the promoter penalty provisions would not apply in some circumstances where they were intended to apply.

1.18 The Government has decided to amend the promoter penalty provisions to ensure that they continue to operate as intended, notwithstanding the amendments to the four year rule.

Summary of new law

1.19 Failing the four year rule does not lead to the denial of a deduction, where this failure is for reasons outside the investor's control. Furthermore, such reasons must not have been able to be reasonably anticipated by the investor at the time they acquired their interest. These two requirements ensure that the reasons for failing the four year holding rule have been genuinely outside the investor's control. This applies to forestry MIS under both Division 394 of ITAA 1997 and section 82KZMG of ITAA 1936.

1.20 The promoter penalty provisions ensure that civil penalties may continue to apply to the promoters of forestry MIS in cases where the investors' deductions are allowed to stand because of the amendments to the four year rule.

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Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Division 394 of ITAA 1997 and Section 82KZMG of ITAA 1936 do <i>not</i> deny deductions to investors in forestry MIS who fail the four year holding rule for reasons genuinely outside their control, provided failing the rule was not reasonably anticipated at the time the investor acquired their forestry interest.	Division 394 of ITAA 1997 and Section 82KZMG of ITAA 1936 deny deductions to investors in forestry MIS who fail the four year rule. However, investors in MIS subject to Division 394 may be entitled to deduct their expenditure under section 8-1 of the ITAA 1997.

Detailed explanation of new law

1.21 The four year holding rule for initial investors in forestry MIS operates to disallow an initial investor's deduction if a CGT event happens in relation to their forestry interest within four years after the end of the income year in which an amount is first paid by the investor. Currently, this rule applies regardless of the circumstances of the CGT event, including if these circumstances are outside the investor's control.

1.22 Under the amendments, where the four year rule is failed because of circumstances genuinely outside the control of the investor, the investor's deduction is allowed, provided that it was not reasonably anticipated at the time that the investor acquired their interest. *[Schedule #, items 1 and 2, subsections 82KZMG(1A) of ITAA 1936 and 394-10(5A) of ITAA 1997]*

Four year rule failed for reasons outside of investor's control

1.23 The holding period rules are failed where a CGT event happens in relation to the investor's forestry interest within four years after the end of the income year in which the interest is acquired. There is a wide range of CGT events that can happen in relation to the forestry interest to cause an investor to fail the rule.

1.24 A CGT event can happen where an investor chooses to sell their interest in a scheme. In these circumstances, an investor's deduction will continue to be denied if this CGT event is within four years of the acquisition of the interest. This is consistent with the underlying policy intent of the four year rule.

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1.25 However, where a CGT event happens such that the four year rule is failed, in circumstances genuinely outside the initial investor's control, the deduction is allowed to stand. [*Schedule 1, items 1 and 2, paragraphs 82KZMG(1A)(a) of ITAA 1936 and 394-10(5A)(a) of ITAA 1997*]

1.26 Situations that could be 'genuinely outside the initial investor's control' include:

- the accidental death of the initial investor;
- the interest in the scheme being compulsorily transferred, because of marriage breakdown or compulsory acquisition by a government;
- the initial investor becoming insolvent;
- the interest in the scheme being cancelled, because of trees being destroyed by fire, flood or drought; and
- the insolvency of the manager of the scheme, leading to the winding up of the scheme.

Example 1.1 CGT event outside investor's control – MIS interest terminated

In June 2006, Frank incurred expenditure to purchase an interest in a forestry MIS operated by TreeGrow Ltd. He claimed a deduction for this expenditure in his 2005-06 tax return under section 82KZMG of ITAA 1936.

In September 2009, TreeGrow encountered financial difficulties and went into voluntary administration. In response, TreeGrow's creditors appointed a liquidator to recover the funds that the creditors had lent to TreeGrow.

The liquidator sold TreeGrow's assets, including the trees in the forestry MIS that Frank owns an interest in and the land on which the trees were planted. As a result, Frank's forestry interest is terminated.

The termination of Frank's interest is a CGT event. The CGT event is genuinely outside of Frank's control because he had no role in the decision to sell the trees and land, which was the direct cause of the CGT event.

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Example 1.2 CGT event outside investor's control – MIS interest swapped

In May 2006, Catherine invested in a forestry MIS that was operated by TreeGrow Ltd. She claimed a deduction for expenditure incurred in the MIS under section 82KZMG of ITAA 1936.

In October 2009, the liquidator of TreeGrow plans to sell the land used in the MIS that Catherine has an interest in. Rather than terminate the interests in this scheme, the plan involves swapping these interests for interests in an ongoing forestry MIS.

The loss of Catherine's original interest is a CGT event. This CGT event is genuinely outside of Catherine's control, because she had no role in the decision to sell the land on which her original interest was based.

The event could not have been reasonably anticipated

1.27 A further requirement is that the event that causes the CGT event could not have been reasonably anticipated at the time that the investor acquired the interest. *[Schedule #, items 1 and 2, paragraphs 82KZMG(1A)(b) of ITAA 1936 and 394-10(5A)(b) of ITAA 1997]*

1.28 This means that it could not have been anticipated by a reasonable person with knowledge of the relevant circumstances.

Example 1.3 CGT event could not have been anticipated

Continuing the scenario in Example 1.1, at the time that Frank invested in the forestry MIS, TreeGrow's public statements and reports did not state that the company was experiencing financial difficulties. At the time, Frank could not have reasonably anticipated that TreeGrow would experience such difficulties in 2009.

Under the existing law, Frank's assessment for 2005-06 would be amended to disallow his deduction because a CGT event happened in relation to his forestry interest within four years of the end of the income year that Frank first incurred expenditure in the forestry MIS.

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Under the amendments, the conditions for allowing the deduction to stand have been satisfied. That is, the CGT event happened for a reason that is genuinely outside Frank's control and the event was not able to be reasonably anticipated in June 2006 when Frank acquired the interest. This means that Frank's assessment will not be amended to deny his deduction.

Example 1.4 CGT event able to be reasonably anticipated – deduction denied

In June 2008, Ben invested in a forestry MIS. He claimed a deduction for his expenditure under Division 394 of ITAA 1997.

The constitution under which the MIS operates allows the scheme manager to compulsorily buy back the interests in the MIS.

In August 2009, the manager chooses to exercise this right and repurchases the interests in the MIS, including Ben's interest.

The sale of Ben's interest back to the MIS manager is a CGT event, which has happened within four years of when Ben first incurred expenditure in the MIS. This CGT event has happened as a result of the manager exercising a right that is conferred upon it by the scheme's constitution.

As the manager's right to repurchase the interest is set out in the constitution, Ben could have reasonably anticipated, at the time that he acquired the interest, that the manager could compulsorily reacquire his interest. Thus, his deduction is not allowed to stand under Division 394.

1.29 An investor acquires their forestry interest when they first incur expenditure in the forestry scheme. This can be before an amount is paid — an amount is usually incurred when there is a definitive obligation to pay it.

Promoter penalties

1.30 The Commissioner can apply to the Federal Court for penalties against the promoter of a forestry MIS covered by an ATO product ruling, if the scheme is implemented in a way that is materially different to that described in the product ruling.

1.31 When considering whether to order the promoter of a forestry MIS to pay that penalty, the Federal Court must disregard the amendments to the four year rules. This ensures that the law continues to deter schemes covered by product rulings from being implemented in a way that is

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materially different from that described in the product ruling. *[Schedule #, item 3, subsection 290-50(2A) of Schedule 1 to TAA 1953]*

1.32 No other changes are made to the promoter penalties provisions. That is, the operation of the promoter penalties otherwise continues to be subject to the existing principles.

Application and transitional provisions

1.33 Schedule # applies to CGT events happening on or after 1 July 2007. This aligns the Schedule with the application of the four year rules, which apply to CGT events happening on or after 1 July 2007. *[Schedule #, item 4]*

1.34 Schedule # contains a transitional provision for taxpayers who have previously had their tax assessment amended to remove the deductions but who would have been allowed the deduction if these amendments had been passed at the time. This transitional provision allows the investor's tax return to be amended for up to four years after the CGT event happened. *[Clause 4]*

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