

16 April 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

Submission - A Platform For Consultation

We enclose two submissions by Namoi Cotton Co-operative Ltd in respect of Tax Reform. These relate to the taxation of distributions on unique financial instrument - Co-operative Capital Units and a submission on the treatment of hedging transactions. Namoi has no objections to either of these submissions being publicly released in their entirety.

If you have any queries in relation to these submissions please contact any of the following people:

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We look forward to further dialogue with you on these important submissions.

Yours sincerely

Allan Jones
Chief Executive Officer

1.0 Executive Summary

Namoi is a co-operative association of cotton growers formed under the NSW Co-operatives Act. It operates in the NSW and QLD cotton growing areas and is Australia's largest cotton processor, (Section 2.0).

The NSW Co-operatives Act provides for co-operatives to issue a unique form of security or financial instrument - Co-operative Capital Units. CCUs are a unique financial instrument which have been described as a hybrid instrument, with some of the features of debt, and other features of equity, (Section 2.2).

Namoi has issued such Co-operative Capital Units, and the units are listed on the ASX. To our knowledge, Namoi is the first co-operative in Australia to issue such CCUs, but following the successful listing of Namoi's CCUs on the ASX, it is likely that more co-operatives will issue such securities, (Section 2.3).

The current taxation regime does not adequately address the tax treatment of Co-operative Capital Units. In order that double taxation of profits does not occur, it is necessary to ensure that the distributions on the CCUs are either frankable or deductible, (Section 3.1).

Namoi Cotton supports many of the reforms suggested in *A Platform for Consultation* but submits that the Review of Business Taxation should specifically address the taxation treatment of Co-operative Capital Units due to their unique features, (Section 4.0).

Based on the features of the CCUs, Namoi believes that the CCUs should be treated as equity, and subject to the franking regime. As the CCUs are issued to holders who are not necessarily "members" of the co-operative, they should be excluded from the operation of Division 9, (Section 4.1).

Namoi supports the retention of Division 9 taxation rules applying to co-operatives in relation to their activities with members, (Section 4.2).

Namoi supports the current imputation system of taxing company distributions, but believes that it should be extended to include distributions on Co-operative Capital Units, (Section 4.3).

In the event that changes to the franking regime are considered necessary, Namoi recommends "Option 3" in Chapter 15 of *A Platform for Consultation* as this would be a simple and easily understood change to the current regime, (Section 4.4).

Namoi **does not** support the deferred company tax model as it would be complicated, confusing to shareholders, and adversely impact on the company's reported profits, (Section 4.4).

Namoi supports a system which will provide timely refunds to CCU Holders of excess franking credits, (Section 4.5).

2.0 Background

Namoi is a co-operative association of cotton growers in the NSW and QLD cotton growing areas and is Australia's largest cotton processor. Its corporate head office is located in Wee Waa in rural NSW.

2.1 Activities of the Co-operative

The principal activities of the co-operative are the ginning and marketing of cotton and the marketing of cotton seed grown by the grower members. This accounts for the majority of the Co-operative's activities, with a small amount of marketing and ginning services provided to non-members.

Raw cotton is marketed to both Australian customers, and overseas markets, principally in Japan, Asia and Europe. Approximately 90% of the cotton produced is sold to overseas customers. The cotton seed is sold for use in seed oil production or for use as stockfeed.

The Co-operative is a leading player in the ginning and marketing sectors of the cotton industry in Australia. The industry produced cotton to the value of \$1.5B in 1997/98. The Co-operative currently has approximately 30% of the ginning market and 32% of the marketing of the total Australian market.

There is currently a "share-holding" requirement for growers based on the number of hectares of land growing cotton. The "shares" may only be held by active growers, who must farm a minimum of 40 hectares to be considered active, and at least 20% of their ginning and marketing must be carried on with Namoi. Each grower holds 800 "grower shares" which have a value of \$2.70 per share. Consistent with co-operative principles, each block of grower shares entitles the grower to one vote. There is only a limited ability to transfer the shares. Thus the critical feature of the shares in the Co-operative is that they come with a responsibility. That responsibility is to comply with the strict membership requirements set out under the *NSW Co-operatives Act* and in the Rules of the Co-operative. Shares are usually only disposed of on ceasing to be an active grower, and in this case they are redeemed by the Co-operative at a value of \$2.70 per grower share.

Co-operatives have a number of structural impediments to growing and competing in the marketplace. One of the principal impediments is a lack of access to capital. Members generally only have a nominal capital investment in the Co-operative. Co-operative membership is generally limited to those actively carrying on business in the industry and therefore access to wider capital markets is restricted. In addition, due to the nature of the share interests held by members, there is little incentive to invest additional capital with the Co-operative. This is due to the fact that additional shares will not increase the grower's voting percentage, and the additional shares will not carry significant dividend rights, nor will growers be able to share in any underlying appreciation in value.

2.2 Capital Raising by Co-operatives

A number of significant Australia wide regulatory initiatives have improved the capital raising flexibility for co-operatives. In particular, the NSW Co-operatives Act now permits co-operatives to issue securities of value - Co-operative Capital Units (“CCUs”) - to outside interests and the Australian Stock Exchange now permits the listing of CCUs by co-operatives wishing to retain grower control.

The second reading speeches at the time the *Co-operative’s Bill 1991* (subsequently reintroduced as the *Co-operative’s Bill 1992*) was adopted indicate that the legislative intention facilitating the introduction of CCUs was to provide co-operatives with broader access to additional sources of capital.

The *Co-ops Act* contemplates the issue of CCUs to persons who may not be members of the co-operative and who may not satisfy the active membership criteria. On this basis the scheme of the *Co-ops Act* necessarily requires that CCUs are not defined to be “shares”. This is because the term “share” is used throughout the *Co-ops Act* and “shares” in a co-operative are only to be held by active members. However, that distinction does not lead to the result that a CCU is not an interest in the equity capital of a co-operative.

The second reading speeches for the *Co-operative’s Bill 1992* describe CCUs as:

*“a form of non-active member capital”*¹

The speeches also draw a distinction between CCUs and debt:

*“Co-operative Capital Units allow co-operatives to have a new source of capital, a new way to get away from debt associated funding through borrowing from banks and to move towards funding from their own operations out of their own capital system.”*²

The second reading speeches clearly indicate that it was the legislative intention to create an alternative source of capital, which could be raised by co-operatives from members and non-members alike. The *Co-ops Act* supports this view by expressly enabling CCUs to be issued to a person whether or not they are members of the co-operative³, and by referring to CCUs as an “interest in the capital”⁴.

It appears that under the *Co-ops Act*, CCUs have characteristics the same as the customary characteristics of shares, in that CCUs provide the holder with an interest in the capital of the co-operative and not simply rights enforceable against the co-operative, as would customarily be held by a creditor. The term “CCU” - Co-operative Capital Units indicates, *prima facie*, that the securities should be regarded as an interest in the capital of the co-operative. The *Co-ops Act* specifically contemplates that a CCU would provide its holder with rights such as entitlements to dividends, an entitlement to receive a distribution of the surplus assets on a winding up and certain voting rights.

¹ Second reading speeches - 11 December 1991 and 9 April 1992 (Legislative Assembly) and 5 May 1992 (Legislative Council).

² Second reading speeches - 30 April 1992 (Legislative Assembly).

³ Section 271.

⁴ Section 269.

To our knowledge, Namoi is the first co-operative in Australia to issue such CCUs, but following the successful listing of Namoi's CCUs on the ASX, it is likely that more co-operatives will issue such securities.

2.3 Namoi's Co-operative Capital Units

Namoi has issued CCUs to both growers, and outside parties. These CCUs are called "Namoi Capital Stock" and are listed on the ASX. These CCUs are specifically provided for under Part 10 Division 2 of the *NSW Co-operatives Act* to provide co-operatives with greater access to capital.

CCUs are defined in section 269 of the *NSW Co-operatives Act* as:

"269 General nature of CCU

(1) A co-operative capital unit is an interest issued by a co-operative conferring an interest in the capital (but not the share capital) of the co-operative.

(2) A CCU:

(a) is personal property,

(b) is transferable or transmissible as provided by this Act and the rules of the co-operative, subject to the terms of issue of the CCU,

(c) is, subject to the rules of the co-operative, capable of devolution by will or by operation of law. ..."

The CCUs have terms very similar to that of non-voting ordinary shares. The CCUs are entitled to dividends, and Namoi stated in its prospectus that it intended to pay 60% of its after tax profits as dividends. The CCUs are entitled to all of the surplus assets and profits of the Co-operative after the fixed claims of the growers shares are satisfied. The CCUs are able to be freely transferred although a restriction applies to any one holder having greater than 15% of the CCUs on issue. Holders of CCUs have the right to nominate 2 Directors to the Board of the Co-operative, but otherwise have limited voting rights.

3.0 Taxation Treatment of Co-operative Capital Units

As CCUs are unique financial instruments which have been described as a hybrid instrument, with some of the features of debt, and other features of equity. The following table outlines the features of the CCUs.

Features of “Shares”	CCUs	Comments
Entitled to payment of “dividends”	✓	The return to the CCU holders is described as a “distribution”
Dividends paid are usually determined by reference to the company’s profits	✓	The amount of the distribution is determined by reference to the profits of the co-operative.
Entitled to surplus on winding up, after return of paid up capital.	✓	The CCUs are entitled to the surplus of the co-operative, after return of paid up capital on the grower shares.
Usually entitled to vote	✗	The CCU holders have limited rights to vote.
Represents part of the ownership of a company.	✓	The CCU holders are regarded as “owners” of the company, and are entitled to appoint representatives to the board of directors.
Treated as “Equity” for accounting purposes	✓	The par value and premium associated with the CCUs are disclosed in the equity portion of the balance sheet.
Taken into account in Earnings per Share calculations.	✓	The CCUs are the basis for calculating the “Earning per share” of the Co-operative.
Features of Debt		
Entitled to Interest	✗	The return on the CCUs are not referred to as “interest”
Interest determined at a fixed percentage amount	✗	The return is not determined as a fixed percentage amount.
Interest is usually paid periodically	✗	The return on the CCUs does not relate to the period the

CCUs are held.

Entitled to Repayment of funds advanced	x	The CCUs do not carry any right of redemption.
Treated as a “liability” for accounting purposes	x	The CCUs are not treated as a liability for accounting purposes.

3.1 Namoi’s Concerns - Current Law

As a unique financial instrument, the current taxation regime does not adequately cater for Co-operative Capital Units. In order to ensure that double taxation of profits does not occur, it is necessary under the current regime to ensure that the distributions on the CCUs are either deductible, or frankable.

Section 120 of the Income Tax Assessment Act provides that dividends paid by co-operatives are deductible to the co-operatives. However, the Australian Taxation Office (“ATO”) has ruled that distributions by CCUs do not fall within section 120. Similarly under the current regime, in order to pass on imputation credits, distributions must fall within the definition of a “frankable dividend”. Again the ATO has ruled effectively that the distributions on the CCUs are not able to be franked.

The following table compares the current treatment of ordinary frankable dividends, tax deductible co-operative dividends, and contrasts these with the treatment of distributions on Co-operative Capital Units.

Entity Level	Current - Frankable Dividends	Current - Cooperative Dividends	Current - CCUs
Accounting Profit	100	100	100
Company Tax	36	0	36
Reported Profit (Distribution)	64	100	64
Individual Investor			
Distribution Received	64	100	64
Gross Up	<u>36</u>	<u>-</u>	<u>-</u>
Taxable Income	100	100	64
Personal Tax (@47%)	47	47	30
Imputation Credit	<u>36</u>	<u>-</u>	<u>-</u>
Tax Payable	11	47	30
Summary of Overall Tax			
Entity level	36	0	36
Individual	11	47	30
Total Tax	47	47	66
Overall Effective Tax Rate	47%	47%	66%

This table shows that the current taxation treatment of CCUs is unfair, creates inefficiencies and results in double taxation of Namoi's distributions. This is contrary to the stated policy of both the imputation and co-operative taxation regimes.

4.0 Review of Business Taxation

Namoi Cotton supports many of the reforms suggested in *A Platform for Consultation* but submits that the Review of Business Taxation should specifically address the taxation treatment of Co-operative Capital Units due to their unique features.

4.1 Taxation of Debt/Equity Hybrids

A Platform for Consultation - Chapter 7 discussed the treatment of debt/equity hybrid instruments. It accepts that the current regime can result in punitive tax treatment applying to arrangements which have commercial advantages. The taxation of Co-operative Capital Units is clearly such a situation. The instrument has been devised for wholly commercial reasons - to raise capital while keeping grower control - yet the taxation regime penalises the stockholders by subjecting them to an effective 66% tax rate (double taxation of distributions).

Namoi accepts that there should be a boundary in the taxation law between the treatment of debt and equity. However, whichever of the options is used to distinguish between debt and equity, Namoi submits that distributions on instruments should either be treated as deductible, or frankable. Namoi supports the view that the purpose of the law should be to facilitate the use of hybrids by taxing them appropriately. If an instrument is categorised as a debt instrument, returns should be deductible to the issuer, and if it is categorised as an equity instrument, the returns should be franked. There may be limited circumstances where anti-avoidance provisions may be necessary resulting in punitive taxation treatment. However such provisions should not apply to genuine commercial instruments such as Co-operative Capital Units.

Namoi supports the "blanket" approach to determining the debt or equity characteristics of hybrid arrangements rather than a bifurcation approach, because of the increased complexity such an approach would cause. Based on the balance of features of the CCUs, Namoi believes that the CCUs should be treated as equity, and subject to the franking regime. As the CCUs are issued to holders who are not necessarily "members" of the co-operative, they should be excluded from the operation of Division 9.

4.2 Taxation of Co-operatives

Namoi supports the retention of Division 9 taxation rules applying to cooperatives in relation to their activities with members. The nature and objectives of co-operatives differ from ordinary companies, as they are founded on the basis of mutuality. A co-operative earns its income from activities with its members. In Namoi's case, these are the grower shareholders.

Division 9 provides a regime which allows for the taxation of the income derived by the co-operatives which is principally from transactions with members, by effectively taxing the income when it is distributed to the members either in the form of rebates, or dividends to members. This is implemented by allowing a deduction to the co-operative for rebates and bonuses paid to members, and allowing a deduction for dividends or interest paid to members.

Namoi pays a number of rebates to grower shareholders based on commercial activities. Namoi submits that such rebates or bonuses paid to grower shareholders based on commercial activities should be allowable as a deduction to the co-operative, and assessable in the hands of the grower shareholders in the year to which the commercial activities relate. Any regime which attempts to treat rebates paid to members solely due to their capacity as shareholders, should be limited in its operation so as not to affect genuine commercial arrangements for the calculation of rebates.

Namoi supports the continuation of deductions allowed to co-operatives in respect of the payment of dividends or interest on shares held by members.

Namoi supports the view that the deduction for repayment of government loans should be maintained, even if cooperatives were otherwise taxed as companies.

4.3 Taxation of distributions on Co-operative Capital Units

It is important on the grounds of efficiency and equity that the distributions on CCU's are either deductible to the co-operative, or able to be franked. Namoi submits that distributions on CCUs should be able to be franked. If Division 9 of the Income Tax Assessment Act is maintained, distributions on CCUs should be made frankable, while distributions on members shares could still remain deductible, (in fact Namoi does not pay any dividends on its member shares). This dual approach is appropriate within the co-operative regime, as the holders of Co-operative Capital Units, are not "members" of the co-operative, and as such, distributions on the CCUs should not be subject to the same principles as distributions to "members" on shares. Alternatively, if this was not supported by the Committee, deductions should be allowed for distributions on CCUs.

4.4 Changes to the Imputation Regime

Namoi supports the current imputation system of taxing company distributions, but believes that it should be extended to include distributions on Co-operative Capital Units (regardless of any changes to Division 9). Franking of distributions on CCUs could easily be achieved by simply amending the definition of "dividend" and "frankable dividend" to include distributions on CCUs.

Chapter 15 of "A Platform for Consultation" states that the distinction between franked and unfranked dividends adds complexity at the shareholders level and at the company level. Namoi does not accept this statement. For the majority of dividends paid, the current franking system works well. It is clearly understood by investors, and is relatively simple in most cases to administer. In the majority of cases, dividends can either clearly be fully franked, or are unfranked. It is usually a fairly simple task for a company to determine its "required franking amount". After 12 years of the imputation regime, investors understand the implications of franked and unfranked distributions, and the reasons for such differences.

The current tax regime has a number of complicated anti-avoidance provisions to attack particular perceived misuses of the franking regime. Rather than re-designing the entire franking regime,

Namoi submits that a clear policy decision be made regarding the circumstances in which franking benefits can be utilised, and simplified anti-avoidance provisions be enacted to catch breaches of this policy, while not affecting genuine commercial activities.

In the event that changes to the franking regime are considered necessary, Namoi prefers “Option 3” in Chapter 15 of *A Platform for Consultation* as this would be a simple and easily understood change to the current regime. For the majority of shareholders, there would be little change to the current taxation arrangements, as distributions paid to private companies are not rebateable under the current regime. Namoi **does not** support the deferred company tax model as it would be complicated, confusing to shareholders, and adversely impact on the company’s reported profits.

4.5 Refunds of Excess Imputation Credits

Namoi supports a system which will provide timely refunds to CCU Holders of excess franking credits. If investors were required to wait until assessment in order to receive a refund, this would place unreasonable cash flow constraints on investors. A large number of investors in Namoi are rural farmers, for whom timely cash flow is critical. Namoi supports a system which would provide for refunds of excess imputation credits throughout the year, with a reconciliation on assessment. Investors should be able to provide a reasonable number of estimates of the refund expected, as an investor’s expected tax position may vary significantly throughout the year (especially for operators in the rural sector).

1.0 Executive Summary

Namoi is a co-operative association of cotton growers in the NSW and QLD cotton growing areas and is Australia's largest cotton processor. As part of its marketing function, Namoi enters into raw cotton futures and engages in hedges against fluctuations in currency. The futures and exchange contracts are entered into in respect of specific expected future cotton production and serve as a hedge against movements in the price of cotton between the time the hedge is entered into, and the time the cotton is eventually sold.

The accounting treatment is to match the futures or currency hedging gains or losses with the underlying transactions.

Namoi believes that the most appropriate taxation treatment of the realised hedging gains and losses is to defer the deduction/assessable gain in relation to hedging transactions until the underlying stock has been sold.

Namoi accepts that there must be some guidelines to ensure that the timing match of the hedge with the underlying transaction is not misused. It is important however that such guidelines are administratively workable, and do not impede commercial decision making. Namoi does not support any timing restrictions on the maximum length of the nominated term of the hedge.

2.0 Background

Namoi is a co-operative association of cotton growers in the NSW and QLD cotton growing areas and is Australia's largest cotton processor. Its corporate head office is located in Wee Waa in rural NSW.

Activities of the Co-operative

The principal activities of the co-operative are the ginning and marketing of cotton and the marketing of cotton seed grown by the grower members. This accounts for the majority of the Co-operative's activities, with a small amount of marketing and ginning services provided to non-members.

Raw cotton is marketed to both Australian customers, and overseas markets, principally in Japan, Asia and Europe. Approximately 90% of the cotton produced is sold to overseas customers. The cotton seed is sold for use in seed oil production or for use as stockfeed.

The Co-operative is a leading player in the ginning and marketing sectors of the cotton industry in Australia. The industry produced cotton to the value of \$1.5B in 1997/98. The Co-operative currently has approximately 30% of the ginning market and 32% of the marketing of the total Australian market.

Hedging Transactions

As part of the marketing function, Namoi enters into raw cotton futures and engages in hedges against fluctuations in currency.

The objective of entering into the cotton futures is to guarantee the price the cooperative will receive when it markets the cotton. The futures and exchange contracts are entered into in respect of specific expected cotton production. However, the transactions are often entered into before the cotton to which they relate has been planted, but are based on estimates of actual production at that date. The contracts serve as a hedge against movements in the price of cotton between the time the hedge is entered into, and the time the cotton is eventually marketed and sold.

Similarly, the objective of entering into the foreign exchange forward contracts is to guarantee the price the cooperative will receive when it markets and sells the cotton to foreign purchasers. Again, the foreign exchange forward contracts are often entered into before the cotton to which they relate has been planted. They serve as a hedge against movements in the exchange rates of the A\$ against the currencies of the cotton purchasers between the time the exchange contract is entered into and the time the cotton is eventually marketed and sold.

Accounting Treatment of FX and Futures Gains & Losses

The cooperative prepares its accounts on an accruals basis. Hence, where gains and losses are made on the cotton futures trading and foreign exchange hedging, the cooperative accounts on a deferral basis. This is done to match the gains and losses in respect of the hedging contracts with the cooperative's revenue from the ultimate sales of the cotton to which the hedges relate.

In this manner the futures or currency hedging gains or losses do not flow through the Profit & Loss account until the underlying stock (the cotton) is actually sold.

The accounting treatment matches the futures or currency hedging gains or losses with the underlying transactions as this provides the appropriate reflection of the cooperatives true profit in relation to the sales of cotton.

3.0 Submission

Chapter 6 of *A Platform for Consultation* recognises that the tax treatment on each side of a hedge may differ. In particular paragraph 6.65-6.66 recognises that hedges may cover future production for considerable periods of time, which will result in a taxing point arising on the rollover of the hedge, without a similar gain or loss arising on the other side of the transaction.

Namoi believes that the most appropriate taxation treatment of the realised hedging gains and losses is to defer the deduction/assessable gain in relation to hedging transactions until the underlying stock has been sold. This would match the taxation treatment with the accounting treatment. The cooperative believes that this method would give a proper reflection of the cooperative's taxable income. The matching of the tax and accounting treatment would prevent wide variations in the cooperatives tax position due to abnormal movements in the cotton price and exchange rates. The purpose of the hedging contracts is to ensure that the ultimate profit of the cooperative is not subject to such wide fluctuations.

The objective of entering into the cotton futures is to guarantee the price the cooperative will receive when it markets the cotton. The futures contracts are often entered into before the cotton to which they relate has been planted. They serve as a hedge against movements in the price of cotton between the time the pool is established and the time the cotton is eventually marketed and sold.

Similarly, the objective of entering into the foreign exchange forward contracts is to guarantee the price the cooperative will receive when it markets and sells the cotton to foreign purchasers. Again, the foreign exchange forward contracts are often entered into before the cotton to which they relate has been planted. They serve as a hedge against movements in the exchange rates of the A\$ against the currencies of the cotton purchasers prior to the time the cotton is eventually marketed and sold.

The accounting treatment is to match the futures or currency hedging gains or losses with the underlying transactions. The cooperative believes that the tax treatment should be the same as the accounting treatment as this gives a proper reflection of the cooperative's taxable income. This prevents the cooperative being taxable or creating losses where there are abnormal movements in the market value of the futures and foreign exchange forward contracts.

Namoi accepts that there must be some guidelines to ensure that the timing match of the hedge with the underlying transaction is not misused. It is important however that such guidelines are administratively workable, and do not impede commercial decision making. Namoi does not support any timing restrictions on the maximum length of the nominated term of the hedge. In the cotton industry, it is common to enter into purchase and sale commitments several years in advance. Such commitments are entered into for purely commercial reasons, and it is important that taxation rules do not limit the ability to hedge purely commercial arrangements.