


CR 2003/30 - Income tax: Membership interests in the Australian Egg Corporation Limited

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Class Ruling

Income tax: Membership interests in the Australian Egg Corporation Limited

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Preamble

*The number, subject heading, and the **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains **Class Rulings** and **Taxation Rulings** TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Class Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are :
- section 6-5 Income Tax Assessment Act 1997 (ITAA 1997)
 - subsections 104-25(1) and (3) ITAA 1997
 - paragraph 104-35(5)(c) ITAA 1997
 - paragraph 104-155(5)(c) ITAA 1997
 - section 108-5 ITAA 1997
 - section 110-35 ITAA 1997
 - subsections 110-45(1B) and (2) ITAA 1997
 - subsection 112-20(1) ITAA 1997

Class of persons

3. The class of persons to whom this Ruling applies are Australian egg producers who are or were the owners of laying hens over 18 weeks owned at the end of the previous financial year for the purposes of the production of eggs for human consumption, and who are or were eligible to be members of the Australian Egg Corporation Ltd ('AECL').

Qualifications

4. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

5. The class of persons defined in this Ruling may rely on its contents provided the arrangement described below at paragraphs 9 to 25 is carried out in accordance with the details of the arrangement provided in this Ruling.

6. If the arrangement described in this Ruling is materially different from the arrangement that is actually carried out:

- (a) this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled, and
- (b) this Ruling may be withdrawn or modified.

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Date of effect

8. This Ruling applies from the 2002/2003 year of income. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of the Taxation TR 92/20). Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the Gazette;
- it is not taken to be withdrawn by an inconsistent later public ruling; or
- the relevant tax laws are not amended.

Arrangement

9. The arrangement that is the subject of the Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- application for Class Ruling dated 21 November 2002;
- constitution of the Australian Egg Corporation Limited;
- Explanatory Memorandum to the Egg Industry Services Provision Bill 2002;
- Explanatory Memorandum to the Egg Industry Service Provision (Transitional and Consequential Provisions) Bill 2002; and
- letter dated 29 November 2002.

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

10. As of 16 January 2003 AECL became the designated Industry Services Body under the Acts and the authority of the Minister by Declaration. As of 1 February 2003, under the Acts, the Minister also declared the transfer of assets and liabilities of the Rural Industries Research and Development Corporation ('RIRDC') egg sub-program to AECL. As such it is now responsible for the industry's research and development ('R&D') previously managed by RIRDC. AECL is also

responsible for managing the generic promotion of the industry through use of the promotion levy receipts, which have been collected from 1 February 2003.

11. The egg industry pays a statutory laying chicken levy which is imposed on hatchery operators per laying chick hatched at a hatchery where 1000 or more laying chicks are hatched for commercial purposes in a year. The levy is imposed through the *Primary Industries Excise Levies Act 1999* and the *National Residue Survey (Excise) Levy Act 1998*. Levy funds are collected under the *Primary Industries Levies and Charges Collection Act 1991*.

12. There are three components to the 7.87 cents laying chicken levy:

- 7.2 cents is distributed to AECL for R&D;
- 0.4 cents is distributed to the National Residue Survey; and
- 0.27 cents is distributed to Australian Animal Health Council.

13. The Commonwealth also makes matching R&D contributions on expenditure to AECL's R&D program of up to 0.5% of the gross value of egg production.

14. In early 2001, the Australian Egg Industry Association ('AEIA') presented the Government with a proposal to form an industry owned company to undertake industry service provision, including generic promotion and the R&D functions that were previously provided by the RIRDC.

15. The proposal also included the imposition of a new promotional levy on egg producers, at a rate of 32.5 cents per laying chick purchased from a hatchery for the purposes of commercial egg production. The levy came into force on 1 February 2003 and will be paid by egg producers, but will be collected by the hatchery operator at the time the producer purchases day old chicks. The new promotional levy is additional to the existing laying chicken levy, but differs from it in that the levy is imposed on the egg producer per chick purchased rather than on the hatchery operator per chick hatched.

16. The Minister of Agriculture, Fisheries and Forestry agreed to a proposal to establish a company limited by guarantee under the Corporations Act. AECL was registered with the Australian Securities Investments Commission on 18 November 2002 and began formal operations under a Statutory Funding Agreement with the Commonwealth on 1 February 2003. AECL was established by the industry as a shelf company with no previous trading history or

activities and its constitution was developed in consultation with government to ensure it captures the intent of the proposal.

17. The company is responsible for egg industry generic promotion, the research and development activities previously provided through the egg sub-program of the RIRDC and other industry service functions.

18. The Egg Industry Service Provision Act 2002 was passed in the Senate on 14 November 2002 and received Royal Assent on 2 December 2002.

19. AECL assumes some of the industry services previously provided by the AEIA. These will include services in relation to animal health and welfare, market access initiatives, product and industrial issues, quality assurance, chemical and pharmaceutical residues standards compliance and economic and non-technical research.

20. The Commonwealth entered into an agreement with AECL regarding the use of statutory levies and matching Commonwealth R&D contributions ('Statutory Funding Agreement') on 1 February 2003. The Statutory Funding Agreement ensures that AECL applies monies received from the Commonwealth for the purposes for which they are collected. There is provision in the legislation to allow the Minister to prescribe the conditions AECL must comply with to be eligible for matching funding.

21. A Board comprising up to seven members will govern AECL. At least two of these will be specialist skilled directors, including one with extensive experience in corporate governance. This requirement is reflected in the Statutory Funding Agreement and in AECL's constitution.

22. All egg producers who pay the statutory promotional levy are eligible to register as members of AECL. This entitles them to receive the annual report, and carry the right to attend, speak and vote at general meetings and appoint directors. Voting rights are based on the number of laying hens over 18 weeks old held by the member (cl 7.2 of AECL's constitution). Membership interests will not be tradeable or transferable (cl.6.10 of AECL's Constitution). Members participate through a delegate system in the election of Board members. Being a member of AECL allows egg producers to have their say in the promotional and R&D priorities of the industry. It also allows them to access support in the service areas that AECL will deliver.

23. Membership interest is subjected to review annually under clause 7.1 of the Constitution.

24. AECL will not act for the individual gain or profit of its members, and members will not receive any dividend from their membership. Upon any winding up of the company, surplus assets will not be distributed to members.

25. The Commonwealth will not be a member of AECL. The Commonwealth's role is limited to imposing and collecting the statutory levies and ensuring the levy monies are used for the purposes for which they have been collected.

Ruling

26. The receipt of membership interests in AECL will not result in an income tax or capital gains tax liability for egg producers.

Explanation

27. The receipt of membership interests in AECL will result in neither an income tax nor capital gains tax liability for egg producers.

Ordinary Income – section 6-5

28. Section 6-5 includes income according to ordinary concepts in the taxpayer's assessable income – that is, ordinary income is included.

29. In order to determine whether the receipt of a membership interest in AECL is ordinary income, it is necessary to consider how the courts have determined when a receipt is ordinary income.

30. *GP International Pipecoaters Pty Ltd v. FC of Taxation* (1990) 170 CLR 124; 90 ATC 4413 provides a useful exposition of when non-current receipts may be ordinary income.

31. The Court held that in determining whether a receipt is of an income or capital nature, various factors are relevant:

‘Sometimes, the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business. The factors relevant to the ascertainment of the character of a receipt of money are not necessarily the same as the factors relevant to the ascertainment of the character of its payment.’ (CLR 138; ATC 4420)

32. Like *GP International*, the elements of periodicity, regularity and recurrence are not present in the receipt of the membership interest in AECL by the egg producers. This fact militates against a conclusion that the receipt is ordinary income. As in *GP International*, in these circumstances there is no right or thing disposed of by the egg producers in exchange for the receipt of the membership interest.

33. The Court in *GP International* noted that the scope of the transaction, venture or business in respect of which the receipt is received and the recipient's purpose in engaging in that transaction will be relevant in the circumstances of that case. The Court went on to analyse the contract under which the taxpayer had received the receipt as critical in determining the scope of the taxpayer's business and the taxpayer's purpose in engaging in the transaction. After analysing the contract the Court concluded that the establishment payments were received by *GP International* as part of the remuneration it earned in the carrying on of its business. Its business was to construct the plant and coat pipe, to perform the contract it had entered into, and therefore receipts under that contract were ordinary income.

34. The question in the present case is whether the scope of the egg producer's business and the egg producer's purpose in entering into the transaction is such that the membership interest given is remuneration earned by the egg producers in carrying on of their business. The membership interest given would not ordinarily be seen as a return within the scope of the business through which the egg producers earn their remuneration. It is not possible to directly link the receipt of the membership interest to the gains of any ongoing trading activity of the egg producer. It is clear that the membership interests are received because the recipient operates a business of an egg producer, however this not to say they are therefore receipts in operating that business.

35. The case *FC of T v. The Myer Emporium (1987)* 163 CLR 199 ('Myer Emporium') also dealt with gains of a transaction that was isolated and extraordinary in terms of its normal business operations. The High Court held that the sum was ordinary income rather than a capital receipt. Despite the fact that the transaction was an isolated transaction it was in the ordinary course of the taxpayer's business. The receipt was held to be ordinary income on the basis of the taxpayer's profit making purpose.

36. Under the test in *Myer Emporium* if the purpose of the egg producers in entering into the arrangement by which they receive membership interest is to make a profit or gain, the profit or gain will be ordinary income. According to the reasoning in *Myer Emporium* the intention of the egg producers would need to be ascertained in

respect of each individual producer at the time the membership interest is given.

37. It is more than likely that the egg producers who get membership interests played an integral part in the planning and development of the arrangement – at the very least, they have been consulted. The motive is unlikely to be a profit making intention in relation to the membership. In fact the principal intention on the part of the egg producers who become members is to have their say in the promotional and R&D priorities of the industry.

38. The receipt of the membership interest by the egg producers is considered to be a receipt on capital account. It is not considered that there is such a nexus between the membership interest and the business activities of the recipient as to consider the receipt to be on income account.

Capital gains

39. A capital gain or loss will only arise when a capital gains tax ('CGT') event happens (subsection 100-20(1)). The most common CGT event is the disposal of a CGT asset (called a CGT event A1). Other CGT events include the cancellation, surrender or similar ending of an intangible asset (CGT event C2), the creation of rights in someone else (CGT event D1) and a receipt for an event relating to a CGT asset (CGT event H2).

Initial members

40. The collective membership rights that each initial member acquires when the constitution is adopted will be a CGT asset (section 108-5).

41. Subsection 104-25(1) provides that CGT event C2 happens if your ownership of an CGT asset ends by the asset:

- (a) being redeemed or cancelled;
- (b) being released, discharged or satisfied;
- (c) expiring; or
- (d) being abandoned, surrendered or forfeited.

So each initial member will have a CGT event C2 when they cease to be a member pursuant to clause 6.5(a) of the constitution. Under subsection 104-25(3), a capital gain arises on the CGT event C2 if the capital proceeds from the asset ending are more than the cost base of the asset. A capital loss arises if the capital proceeds are less than the reduced cost base of that asset.

42. Section 110-35 provides that there are 5 incidental costs you may have incurred to acquire a CGT asset or that relate to a CGT event:

- remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser. However, remuneration for professional advice about the operation of this Act is not included unless it is provided by a registered tax agent or legal practitioner;
- costs of transfer;
- stamp duty or other similar duty;
- costs of advertising to find:
 - a seller (if you acquired a CGT asset); and
 - a buyer (if a CGT event happened); and
- costs relating to the making of any valuation or apportionment for the purposes of the CGT provisions.

43. Subsection 110-45(1B) provides that expenditure does not form part of incidental costs to the extent that you have deducted or can deduct it. And subsection 110-45(2) provides that expenditure does not otherwise form part of the cost base or reduced cost base if you have deducted or can deduct it.

44. It is arguable that the capital proceeds from the cessation of their initial membership will include the market value of the new membership rights an egg producer subsequently acquires on being readmitted as a member. However, we accept that those new membership rights would have negligible value because they cannot be traded or transferred, and members are not entitled to dividends nor a distribution of any surplus if AECL were to be wound up.

45. So any egg producer who is an initial member of AECL will not make a capital gain when their initial membership ceases under clause 6.5(a).

46. Unless the egg producer incurred incidental costs (section 110-35) in acquiring their initial membership rights, it is expected that there will be no capital loss either. This is due to the reduced cost base being zero or negligible, whether or not the market substitution rule of subsection 112-20(1) applies. Accordingly, as the value would be zero or negligible, it would not be greater than any capital proceeds received.

Becoming a member

47. Under the arrangement, an eligible egg producer can become a member of AECL. No CGT events could apply to a such a happening, with the possible exceptions of CGT events D1 and H2.

48. Apart from being a CGT asset (section 108-5), the collective membership rights acquired will qualify as an equity interest in AECL. Paragraphs 104-35(5)(c) and 104-155(5)(c) specifically provide that CGT events D1 and H2 respectively do not happen if a company allots equity interests in the company.

49. So an egg producer will not have a CGT event, or make a capital gain or capital loss merely by becoming a member of AECL.

Ceasing to be a member

50. If under clause 6.9 of the constitution, an egg producer ceases to be a member, their membership rights will end and they will have a CGT event C2 (section 104-25).

51. Under subsection 104-25(3) a capital gain arises on a CGT event C2 happening if the capital proceeds from the ending are more than the cost base of the asset. A capital loss arises if the capital proceeds are less than the reduced cost base.

52. No capital proceed would be received if an egg producer ceases to be a member under clause 6.9 of the constitution, and therefore no capital gain would be made.

53. No portion of the levies paid by an egg producer would form part of the reduced cost base of their membership rights in AECL for two reasons. Firstly, the amount of levies payable is based on an egg producer's laying chick numbers. It is not in any way related to the acquisition or maintenance of their membership rights. Secondly, it is expected that those levies would be deductible expenditure incurred in carrying on a business to derive assessable income, and so excluded from the reduced cost base by subsection 110-45(2).

54. As no other charge is imposed on egg producers in becoming a member of AECL, it is therefore expected that , unless an egg producer incurred incidental costs (section 110-35) in acquiring their membership rights, they would not make a capital loss on ceasing to be a member of AECL.

Detailed contents list

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Commissioner of Taxation

16 April 2003

Previous draft:

Not previously released in draft form.

*Related Rulings/Determinations:*TR 92/1; TR 92/20; TR 97/16;
CR 2001/1*Subject references:*

- Capital
- Capital gains
- CGT event
- Ordinary income

Legislative references:

- ITAA 1997 6-5
- ITAA 1997 104-25(1)
- ITAA 1997 104-25(3)
- ITAA 1997 104-35(5)(c)

- ITAA 1997 104-155(5)(c)
- ITAA 1997 108-5
- ITAA 1997 110-35
- ITAA 1997 110-45(1B)
- ITAA 1997 110-45(2)
- ITAA 1997 112-20(1)
- TAA 1953 Part IVAAA
- Copyright Act 1968
- National Residue Survey (Excise) Levy Act 1998
- Primary Industries Excise Levies Act 1999
- Primary Industries Levies and Charges Collection Act 1991.

Case references:

- FC of T v. The Myer Emporium (1987) 163 CLR 199

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- GP International Pipecoaters Pty
Ltd v. FC of Taxation (1990) 170
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ATO references

NO: 2003/ 003873

ISSN: 1445 2014