

PRODUCT RULING - BR Prd 11/01

This is a product ruling made under section 91F of the Tax Administration Act 1994.

Name of the person who applied for the Ruling

This Ruling has been applied for by StockCo Limited (StockCo).

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of sections BG 1, DA 1(1), DA 2, EA 3, EC 6 to EC 27, EC 32 to EC 37 and EJ 10, subpart EW, and sections FA 6 to FA 11, FA 12 and GC 1.

Because this is a product ruling affecting the deductibility of lease payments for the customers of StockCo (ie, the farmers), the ruling does not consider the effect of the Arrangement on StockCo, StockCo Holdings Limited (StockCo Holdings) or StockCo Residual Limited (StockCo Residual).

The Arrangement to which this Ruling applies

The Arrangement is a sale and lease-back transaction involving livestock. The Arrangement mainly involves dairy cattle, but may also involve sheep. Under the Arrangement StockCo purchases livestock from a farmer and then leases that livestock back to the farmer. (There is also a variation of the Arrangement where StockCo purchases livestock from a third party and leases it to the farmer.)

Once the lease is executed, StockCo assigns the lease income to StockCo Holdings in consideration for the discounted present value of the cash flow receivable under the lease. Further, StockCo sells the residual interest in the livestock to StockCo Residual.

At the end of the lease (after the Lease Termination Date, as defined in the lease agreements), StockCo Residual may sell the livestock to the farmer or a third party. There is no obligation on StockCo to sell, or on the farmer or buy, the livestock. If StockCo Residual does sell the livestock to the farmer, the sale will be at the Residual Value. The Residual Value is an agreed estimate of the value of the livestock at the end of the lease term.

Further details of the Arrangement are set out in the paragraphs below.

1. StockCo is in the business of livestock leasing and financing and is the face of the StockCo leasing business. StockCo Holdings and StockCo Residual are both subsidiaries of StockCo.
2. StockCo has identified a market for livestock leasing in the farming industry.
3. Leases result from one or a combination of the two transactions outlined below:
 - a. StockCo and the farmer enter into a sale and lease-back transaction (for all or part of the farmer's livestock), whereby StockCo buys

livestock from the farmer and then leases the livestock back to the farmer; or

- b. StockCo purchases livestock from a third party, at the farmer's request, and then leases the livestock to the farmer.
4. In the case of the first type of transaction, the Arrangement allows the farmer to realise capital that was tied up in livestock. This capital could be used to retire external debt or fund the expansion of herds, land or the business in general. Farmers also gain certainty of income and expenditure that is not guaranteed under current livestock valuation methods.
5. In the case of the second type of transaction, the Arrangement may assist a new farmer to set up their business, as capital set-up costs can be a barrier for entry into the market. This second type of transaction may also assist existing farmers if, for example, they wish to expand their herd.

Sale of livestock

6. The Master Deed of Dairy Herd Lease is the lease document relating to dairy livestock. Clause 2 of the lease sets out the purchase and ownership provisions in relation to the initial sale of the livestock to StockCo:

2. PURCHASE AND OWNERSHIP OF THE HERD.

- (a) We will purchase the relevant Cows for the Purchase Price on the Commencement Date.
- (b) We will EITHER:
 - (i) Purchase the relevant Cows from you for the Purchase Price and will create a buyer generated invoice and will pay the Purchase Price to you on the Commencement Date or on any other agreed settlement date;OR
 - (ii) Purchase the relevant Cows from another person/s and provide the same to you on the Commencement Date or any other agreed settlement date;OR
 - (iii) Undertake a combination of purchase methods set out in subparagraphs 2(b)(i) and (ii) above.
- (c) You covenant that the Herd will upon acquisition pursuant to this Deed be our absolute property free from any security interest and other encumbrance. You will do all things necessary and further warrant that pursuant to the transfers under clause 2(b) clear title to the Herd has been or will be transferred to us free of any security interest or other encumbrance.
- (d) You covenant that all Progeny will be our absolute property free from any security interest and other encumbrance. You will do all things necessary and further warrant that pursuant to the transfers under clause 2(b) clear title to all Progeny has been or will be transferred to us free of any security interest or other encumbrance.
- (e) You covenant that the Cow Herd Schedule is accurate, the Herd is located on the Land and the Herd is healthy and free from disease.
- (f) Legal and beneficial ownership of the Herd, free of any security interest or other encumbrance will be deemed to be transferred to us on the Commencement Date. We own the Herd.

Lease of livestock

7. Clause 3 of the lease sets out the general lease provision:
 3. **LEASE OF THE HERD.** On completion of the purchase contemplated in clause 2, we will lease the Herd and any applicable Cows to you for the Term in consideration of you paying the Lease Payments, and subject to the covenants, conditions, terms, reservations and restrictions contained in this Deed.
8. Once the lease is executed, the farmer must make lease payments based on their individual cash flow. Dairy farmers usually make the lease payments from December to May each year of the lease. Sheep and beef farmers usually make the lease payments from February to May each year of the lease.
9. The length of each lease may vary. However, the maximum lease periods are five years for cattle and four years for sheep. Supplementary leases may be entered into in respect of replacement or additional livestock.

Assignment of lease and sale of residual interests in livestock

10. StockCo assigns the right to receive the lease payments to StockCo Holdings for the discounted present value of the lease payments receivable under the lease. The discount is equivalent to the market rate offered by third-party companies providing such financing facilities. The assignment is on a non-recourse basis, so StockCo is not liable to StockCo Holdings in the event of default by lessees. StockCo Holdings receives all the rights contained in the lease as applicable during the term of that agreement.
11. StockCo then sells the residual interest in the livestock (the right to the livestock after the termination of the lease) to another subsidiary company, StockCo Residual. The sale price is the present value of the Residual Value (the agreed estimate of the value of the livestock at the end of the lease term). The present value is calculated using market rates used by third-party companies.
12. Clause 23 of the lease allows for the assignment of StockCo's interest in the lease without notice to the farmer:
 23. **ASSIGNMENT, TRANSFER AND AGREEMENT.** You agree that:
 - (a) we may, without giving you or any guarantor notice or obtaining your consent or the consent of any guarantor, at any time, sell, assign, transfer or otherwise dispose of or deal with our interest in this Deed, any related document and any Herd, cows, Progeny or other property the subject of this Deed or any related document;
 - (b) notwithstanding any privacy laws or other requirement of confidentiality, you and any guarantor consent to our disclosing information about you and any guarantor and otherwise in connection with this Deed and any related document for this purpose;
 - (c) neither you nor any guarantor may assign any of your rights or purport to assign or transfer any of your obligations under this Deed or any related document or any Herd, cows, Progeny or other property the subject of this Deed or any related document without our prior written consent;
 - (d) you and any guarantor continue to be bound by this Deed and any related document in all respects following any sale, assignment or other disposal or dealing by us.
 - (e) following any sale, assignment, transfer or other disposal or dealing by us that the assignee or transferee of those rights will have the same rights,

powers, discretions and remedies against you and any guarantor that we have under this Deed and any related document as if it were named as StockCo Limited in this Deed and those related documents; and

- (f) following any sale, assignment or other disposal or dealing by us that each reference to "we", "us" or any other reference to StockCo Limited in this Deed and any related document shall include the assignee or transferee (including, for the avoidance of doubt, under and in respect of any indemnity granted by you).

- 13. The assignment of the right to receive lease payments and the sale of the residual interest will return funds to StockCo. This will provide StockCo with working capital.

Use and maintenance of livestock

- 14. The farmer is responsible for maintaining the livestock. The farmers must maintain the number, quality and type of the herd that is the subject of the lease. In the event of any loss of livestock, a farmer must either replace the livestock or pay StockCo an amount equal to the remaining lease payments. In addition, with StockCo's permission, the farmer may cull stock throughout the life of the lease. In doing so, the lease requires that the farmer acts as agent for StockCo and that any proceeds from the cull are returned to StockCo. Unless exempted by StockCo, the farmer must replace any culled livestock.
- 15. Clause 4 of the lease provides for the protection of StockCo's interest in the livestock and the circumstances under which the farmer has enjoyment over the stock without interruption or disturbance from StockCo:

4. PROTECTION AND QUIET ENJOYMENT

- (a) You must protect our ownership of the Herd and not attempt to sell, hire or otherwise dispose of, or deal with the Herd, or any Cows, in any way other than in accordance with this Deed. You will not use, or attempt to use, the Herd or any of the Cows as security for any loans or other obligation, sell or part with possession of any Cows otherwise than in accordance with this Deed, or register, attempt to register or allow to be registered, any security interest on the Personal Property Securities Register in respect of the Herd or any of the Cows other than by us.
- (b) As long as you make all Lease Payments and duly and punctually observe and perform all your obligations under this Deed, you may peaceably possess and enjoy the Herd without interruption or disturbance from us on the terms contained in this Deed.

- 16. Clause 8 of the lease contains provisions relating to the farmer's expected use and maintenance of the leased livestock:

8. USE AND MAINTENANCE OF HERD

- (a) You will farm the Herd according to the best principles of good animal husbandry and take all possible care for the safety, well-being and security of the Herd and maintain the Herd's number, quality and type.
- (b) You will do all things necessary to maintain a Pregnancy Rate of not less than 80%.
- (c) All costs regarding the farming, health, levies, taxes and any other maintenance or compliance costs are payable by you.
- (d) We may, at any time, determine whether you are in compliance with clause 8(a) or 8(b) and may employ such consultants or persons as in our absolute discretion we think fit to assist in making that determination. You must reimburse us for any fees paid by us to any such persons upon receipt of a written demand, and will pay any fees due direct to any such persons

upon request by us. Any determination by us that you are not in compliance with clause 8(a) and 8(b) will in the absence of manifest error be final and binding on you.

17. Clause 9 of the lease sets out the actions that the farmer must take if there is a loss of any leased livestock:

9. STOCK LOSSES.

- (a) Following the death or loss of any Cow you will immediately notify us of such death or loss setting out the circumstances in which such death or loss took place and whether remedial steps have been taken to protect the remainder of the Herd. If requested by us, you will forthwith produce a report certified by a Veterinary Surgeon as to the fact and cause(s) of death. When a Cow dies or is lost, irrespective of the cause of death or loss, you are responsible for the value thereof and you will within 30 days either:
- (i) replace the Cow with a similar cow, ensuring continuing compliance with clauses 8 and 14; or
 - (ii) pay to us by way of liquidated damages an amount equal to the total agreed lease payments relating to the Cow, less any lease payments received to date and less any rebate which we may in our absolute discretion allow you.
- (b) You are responsible for the removal and disposal of any Cow which has died.

18. Clause 10 of the lease sets out the rights and obligations of the farmer in relation to annual culls and the replacement and variations of leased livestock:

10. ANNUAL CULLS, REPLACEMENTS AND VARIATIONS.

- 10.1 It is agreed that the Herd may be varied by progressive Culling and replacement of dairy Cows forming part of the Herd, provided prior written consent is first obtained from us.
- (a) **Culls.** You may from time to time seek our approval to Cull Cows from the Herd. Following notification (and where approval is given) you are authorised and agree to act as our agent for the removal and disposal of any Cows Culled for any reason from time to time.
 - (b) You must notify us annually before the 31st day of May in every year, with full particulars of the number, age, breed and type of each Cow that you wish to Cull.
 - (c) Following notification (and where approval is given) we will calculate and send you an invoice outlining the residual amount owed by you for each Cow Culled calculated as the total agreed lease payments relating to the Cow, less any lease payments received to date and less any rebate which we may in our absolute discretion allow you.
 - (d) You will pay the residual amount calculated by direct debit from your bank account on a date that is mutually agreed.
 - (e) You are responsible for the removal and disposal of any Cows Culled from the Herd. Upon the receipt of any proceeds received as consideration for the Cows Culled, you agree to hold the proceeds as constructive trustee for us.
 - (f) You shall pay to us GST payable on all payments due under the Deed relating to the Cows which are culled.
 - (g) **Replacements.** You may from time to time seek our approval to lease from us additional Cows or Herds (whether purchased from you or otherwise acquired).
 - (h) Unless otherwise consented to by us, you must replace any Culled Cows, and otherwise ensure that you comply with the requirements as to maintenance of the Herd in clause 8 and to identification as set out in clause 14.
- 10.2 You covenant that all Cows which you provide to replace any Culled Cows or which we provide as additional Cows or Herds:

- (a) form part of the Herd;
- (b) are procured by StockCo in accordance with the same provisions and covenants as are contained in clauses 2 and 3 of this Deed.

19. Clause 14 of the lease sets out the farmer's obligations in relation to the identification and annual verification of the leased livestock:

14. IDENTIFICATION AND ANNUAL VERIFICATION.

- (a) You must at all times ensure that the Herd is separately identifiable from any other cows that may be depastured on the Land.
- (b) You must maintain complete and up to date records and details of each Cow.
- (c) You shall also identify the Herd by means of the Animal Health Board (AHB) Identification System (approved by the Chief Technical Officer on 3 October 1999 and notified in the Gazette 1999, at page 3579) or any other identification system that is approved in its place under the Bio-Security (Animal Identification Systems) Regulations 1999, in the same manner as required in relation to cattle beasts being moved from the herd of origin to another herd. Progeny should also be subject to identification requirements.
- (d) We may request at any time, that you will send to us a written report that certifies the number of Cows and the breed, age, quality, pregnancy status and type. Following such request, you will supply the same within 7 days.
- (e) If, following such report, any Cows are missing then you will be deemed to have Culled the number of Cows so missing and the provisions of clause 10 will apply.
- (f) You must at all times ensure that identification of all Progeny is effected and maintained in accord with all the provisions of clauses 14(a), (b), (c), (d) and (e).

20. Clause 15 of the lease sets out the rights of the parties in relation to the progeny of leased livestock:

15. PROGENY.

- (a) StockCo owns the Progeny and leases to you the Progeny with effect from their birth (until transfer thereof).
- (b) StockCo holds a first ranking security interest over the Progeny.
- (c) StockCo may upon your written request transfer to you ownership of any Progeny, for nil consideration, which are not now and will not at any time in the future be Cows provided that you are not in default or in breach of this Deed.
- (d) You are entitled to revenue from the Progeny.

Termination

21. After the termination of the lease, the farmer may offer to purchase the livestock from StockCo Residual (as noted above, StockCo Residual purchases the residual value of the livestock from StockCo at the beginning of the lease). StockCo Residual is under no obligation to accept the farmer's offer (see clause 13 set out in paragraph 22). If the farmer does not purchase the livestock after the lease expires, StockCo Residual will try to sell the livestock for at least the Residual Value of the livestock. If the sale price StockCo Residual receives is less than the Residual Value, the farmer must pay the difference to StockCo Residual. If the sale price is greater than the Residual Value, StockCo Residual must pay the excess to the farmer. In either case, the net proceeds received by StockCo Residual will generally be equal to the Residual Value, no more and no less.

22. Clause 13 of the lease sets out the termination provisions:

13. **TERMINATION.** At the expiry or earlier termination of this Deed you must, at your cost, deliver to us the Herd forthwith, and in any event within 5 business days.
- (a) If you fail to deliver the Herd to us in the time period specified, we may collect and remove the Herd from the Land or any land where we believe the Herd may be located, and you hereby authorise us to do so, and you will be liable to us for any cost, loss, expense or liability in so collecting and removing the Herd.
 - (b) Upon termination of this Deed, whether by way of early termination, or otherwise we may sell the Herd to any person we choose, in our absolute discretion, using any reasonable method.
 - (c) Upon termination by expiry, we reserve the right to sell the Herd at then current market value, AND in the event that we exercise such right then we will endeavour to effect sale for a price no less than the Residual Value and to do so within 30 days after termination. Upon sale of the Herd, if the Net Proceeds:
 - (i) are less than the Residual Value, you must pay us the difference between the Residual Value and the Net Proceeds;
 - (ii) are greater than the Residual Value, we must pay to you the difference between the Residual Value and the Net Proceeds.
 - (d) You may offer to purchase the Herd, but we are under no obligation to sell the Herd to you.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

- a) At the time the lease is entered into the Residual Value of the stock is a reasonable, and the parties' best, estimate of the likely market value of the stock at the Lease Termination Date.
- b) The customer is in the "business" (as defined by section YA 1) of farming.
- c) The customer has entered into the lease for the sole purpose of undertaking a farming business and intends to use the leased stock in the production of assessable income.
- d) The lease payments are genuine, arm's length amounts for the possession and use of the stock.
- e) The customers will enter into the leases for one or more of the following business reasons that are, in each case, the main reason or reasons for entering into the Arrangement. The possible reasons are the need:
 - to refinance livestock already owned for further investment in the farming business or to retire existing debt;
 - for certainty of cash flows through structuring the lease payments;
 - for certainty of income and expenditure; and/or
 - to reduce the initial level of cash required to enter the farming industry or to purchase new livestock.
- f) With one exception, neither StockCo, StockCo Residual, nor StockCo Holdings will, directly or indirectly, assign or otherwise dispose of any livestock lease interest to a lessee farmer or a person associated with a

lessee farmer. The exception is a sale of the residual interest in the livestock to a lessee farmer on the termination of the lease and as contemplated in the livestock lease. For the purposes of this condition, a livestock lease interest includes the right to receive lease payments, the residual interest or any other interest in the lease.

- g) The livestock becomes the property of the customer only if the customer makes payment of the Residual Value after the Lease Termination Date, subject to approval by StockCo.
- h) The customer is not in the "business" (as defined in section YA 1) of selling or exchanging leases.
- i) At the time of entering into each lease, the customer does not intend to dispose of the lease.
- j) The customer is not carrying on or undertaking a scheme of trading leases entered into or devised for the purpose of making a profit.
- k) The livestock, when purchased by the customer after the Lease Termination Date, are not used in, or as part of, a stock-dealing "business" (as defined in section YA 1).

How the Taxation Laws apply to the Arrangement

Subject in all respects to any assumption or condition stated above, the Taxation Laws apply to the Arrangement as follows:

- The livestock lease payments are deductible under section DA 1(1) and none of the general limitations in section DA 2 applies to prevent deductibility, provided that:
 - no provision in subparts DB to DZ applies to prevent a deduction in section DA 1(1); and
 - the income arising from the Arrangement is derived by the taxpayer in New Zealand.
- The valuation provisions in sections EC 6 to EC 27 apply to the customer when the "specified livestock" (as defined in section YA 1) is purchased by payment of the Residual Value after the Lease Termination Date.
- The valuation provisions in sections EC 32 to EC 37 apply to the customer when the "high-priced livestock" (as defined in section YA 1) is purchased by payment of the Residual Value after the Lease Termination Date.
- The cost price of the "specified livestock" (as defined in section YA 1) for the purposes of sections EC 6 to EC 27, for customers purchasing that livestock at the end of the lease, is the Residual Value stated in the lease.
- The cost price of the "high-priced livestock" (as defined in section YA 1) for the purposes of sections EC 32 to EC 37, for customers purchasing that stock at the end of the lease, is the Residual Value stated in the lease.
- At the end of an income year, unless excused from this requirement pursuant to a determination issued by the Commissioner, section EA 3

applies to require the unexpired portion of any lease payments paid in advance to be included in the customer's income in the current income year and to be an amount for which the customer is allowed a deduction in the following income year.

- The financial arrangements rules in subpart EW do not apply to the Arrangement.
- Section EJ 10 does not apply to the Arrangement because the lease is not an operating lease.
- Sections FA 6 to FA 11 do not apply to the Arrangement because the lease is not a finance lease.
- Section FA 12 does not apply to the Arrangement because the lease is not a hire purchase agreement.
- Section GC 1 does not apply to the sale of livestock by StockCo Residual to the farmers.
- Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2011 and ending on 31 March 2016.

This Ruling is signed by me on the 1st day of April 2011.

Martin Smith
Chief Tax Counsel