PRODUCT RULING - BR Prd 12/08

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

Name of the Person who applied for the Ruling

This Ruling has been applied for by Fonterra Co-operative Group Limited (Fonterra).

Taxation Laws

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

This Ruling applies in respect of ss BG 1, CX 56, CX 56B, FC 2, subpart HM and the definition of "foreign investment variable-rate PIE" in s YA 1.

The Arrangement to which this Ruling applies

The Arrangement is the establishment and operation of the Fonterra Shareholders' Fund (FSF), a New Zealand resident unit trust through which non milk-supplying investors (Public Investors) and farmers supplying milk to Fonterra (Supplying Shareholders) will be able to invest in units. Units in the FSF will give Public Investors and Supplying Shareholders economic rights in Fonterra shares (Shares), but will not provide them with any legal interest in the Shares.

Units in the FSF will be issued when a Supplying Shareholder, registered volume provider (RVP) (whose Shares will be held in the name of the Custodian on trust for the RVP), or Fonterra has transferred the legal ownership of Shares to the Custodian. The Custodian will hold the economic rights in those Shares on trust for the trustee of the FSF (Unit Trustee).

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

Parties to the Arrangement

1. The parties to the Arrangement include:

- Fonterra;
- The FSF (through the Manager or Unit Trustee);

- The trustees of the Fonterra Farmer Custodian Trust (the Farmer Trustees);
- The Custodian;
- The Unit Trustee;
- The manager of the FSF (Manager);
- Supplying Shareholders;
- RVPs; and
- Public Investors.

2. Supplying Shareholders, RVPs, the Farmer Trustees, Fonterra and Public Investors may invest in the FSF. Together, they are referred to as the Unit Holders.

Documents relevant to the Arrangement

3. The following documents are relevant to the Arrangement:

- Unit Trust Deed (which establishes the FSF) (Unit Trust Deed);
- Authorised Fund Contract, under which the FSF will be established as an “Authorised Fund” under Fonterra’s Constitution;
- Trust Deed of the Fonterra Farmer Custodian Trust, which will hold all of the shares in the Custodian and the Fonterra Unit;
- Custody Trust Deed of the Fonterra Economic Rights Trust, under which the Custodian will hold the legal title to Shares and the economic rights in Shares on trust for the Unit Trustee; and
- Form B of Fonterra’s constitution (Form B Constitution), which will come into force if Trading Among Farmers is implemented.

Background to the Arrangement

4. Fonterra is simultaneously registered as a co-operative dairy company under Part 3 of the Co-operative Companies Act 1996 and as a company under the Companies Act 1993 (Companies Act). Many aspects of Fonterra's structure and operation are governed by the Dairy Industry Restructuring Act 2001 (DIRA).

5. Supplying Shareholders must generally hold such number of Shares as is determined by the share standard (currently set in Fonterra’s constitution as being one share for each kilogram of milksolids obtainable from milk supplied by the farmer in that season, save that Shares cannot be issued to a farmer whose supply of milksolids is less than 1,000kg in a season). These Shares are informally known as “wet” shares, as they are backed by the supply of milk. In practice, Supplying Shareholders must indicate in advance how much milk they wish to supply in a coming season, and they must acquire or dispose of the appropriate number of Shares in order to back that supply (within certain margins).

6. In addition to their “wet” Shares, Supplying Shareholders may currently acquire further Shares (up to 20% of the number of shares that they are required to hold under the share standard). These Shares are informally known as "dry" Shares, as they are not backed by the supply of milk. Despite the informal distinction between wet Shares and dry Shares, all Shares of Fonterra belong to a single class of Shares.

7. Under s 98 of the DIRA, Fonterra must pay a surrender value for Shares when a notice of withdrawal is given by a Supplying Shareholder under s 97 of the DIRA. The ability for farmers to surrender their Shares has led to volatility in Fonterra's capital. For example, the surrender value for Shares withdrawn in 2008 was approximately $600 million as a result of droughts occurring in 2008, with production increasing to pre drought levels in 2009. Fonterra refers to this volatility as redemption risk.

8. To address this redemption risk, Fonterra has made, or is proposing to make, a number of changes to its capital structure in three stages. The proposal, referred to as Trading Among Farmers, includes:

   (i) enabling farmers to acquire up to 100% of the number of Shares that they are required to hold under the share standard as dry Shares.

   (ii) the establishment of a Fonterra shareholders’ fund that will enable public investment (ie the FSF).

   (iii) the creation of a “private market” for the trading of Shares between Supplying Shareholders, RVPs (whose Shares will be held in the name of the Custodian in trust for the RVP) and Fonterra (the Fonterra Shareholders’ Market (FSM)). Fonterra is involved in the FSM so that it can manage the size of the FSM by conducting buybacks of Shares.

9. The Trading Among Farmers proposal has required amendments to be made to the DIRA, to remove the requirement for Fonterra to accept the surrender of Shares on request. This amendment when it is brought into force, by Order-in-Council, will remove the redemption risk.

10. The current constitution of Fonterra is the Form A Constitution. The Form A Constitution sets out the framework for the Board of Fonterra to take steps to implement Trading Among Farmers, including the pre-conditions that must be satisfied and the implementation time period. If Trading Among Farmers is implemented, the Form B Constitution, which contains rules relating to the FSM, the FSF and RVPs, will apply.

The Arrangement

11. Fonterra will establish, or procure the establishment of, the FSF – a passive investment vehicle through which a Public Investor can invest indirectly in Fonterra. The FSF will be established as a unit trust under the Unit Trusts Act 1960.

12. As the FSF intends to have investors who are not resident in New Zealand, the FSF will elect to be a “foreign investment variable-rate PIE” (as defined in s YA 1) and will notify the Commissioner of that election.

13. The purpose of the FSF is to provide support to the FSM by acting as a conduit for Public Investors to access the underlying economic rights in a Share, thereby creating a more liquid market for Supplying Shareholders (and RVPs) to trade in Shares. This mechanism will allow Supplying Shareholders to sell economic rights in Shares to the FSF, as well as selling Shares on the FSM. It will also allow an RVP to move between the FSF and FSM to match supply and demand and possibly hedge its position. While Supplying Shareholders may invest in the FSF, it is anticipated that most of the Unit Holders will not be Supplying Shareholders.

14. Fonterra will initially appoint one RVP (although it retains the discretion to appoint further RVPs) to acquire and dispose of Shares (through the Custodian) on the FSM to facilitate trades and liquidity in that market. The principal duties of the RVPs are to ensure the smooth execution of transactions and improve liquidity through continuous quoting of both buy and sell orders with a contracted maximum spread between the buy and sell prices quoted. A key role of the RVPs will be to ensure that the spread between buy and sell prices is restricted to a narrow range.

15. Under the Form B Constitution, RVPs must hold, in aggregate, rights or interests in no more than 5% of the total Shares on issue at any time, excluding treasury stock (such Shares being held in the name of the Custodian in trust for the RVP). Fonterra and the RVPs will not enter into a risk sharing agreement, however where the RVP is suspended from selling economic rights in relation to Fonterra shares to the FSF, Fonterra will compensate the RVP for certain trading losses suffered by the RVP.

16. Like Supplying Shareholders, RVPs will also be able to participate in the FSF. This will promote price convergence between the FSM and the FSF.

The Unit Trustee, the Manager and the Custodian

17. Fonterra will appoint the initial Unit Trustee as trustee of the FSF. The Unit Trustee holds a licence under the Securities Trustees and Statutory Supervisors Act 2011.

18. Fonterra will also appoint the initial Manager of the FSF. The Manager will initially be a company wholly owned by Trustees Executors Limited. Under the Unit Trusts Act 1960, the role of the Manager is to manage the investments of the FSF and issue Units to the public. The Manager will manage the FSF as an investment vehicle and will not undertake an active role (such as actively soliciting farmers to sell economic rights in their Shares). Fonterra will provide a licence (the Licence) to the Manager to use Fonterra's name and brand for the purposes of the FSF.

19. The Unit Trustee and Manager will be party to an arrangement with Fonterra under which Fonterra will provide the FSF with funds (the Funding Arrangement) to cover the reasonable expenses incurred by the FSF, or the Manager, on behalf of the FSF (Operating Expenses).

20. The Custodian will be a limited liability company set up to hold legal title to Shares. The Custodian will hold legal title to any Shares in which economic rights have been sold to the FSF, and will hold the economic rights in Shares on trust for the Unit Trustee (under the Fonterra Economic Rights Trust). The Custodian will also hold legal title to any Shares acquired by the RVP, on trust for the RVP (under a separate trust from the Fonterra Economic Rights Trust).

21. The Custodian will be wholly-owned by the Farmer Trustees, as trustees of the Fonterra Farmer Custodian Trust. The Fonterra Farmer Custodian Trust will be a trust set up for the sole purpose of holding the shares in the Custodian and the Fonterra Unit, which confers on the holder rights to prevent certain changes to the Unit Trust Deed (see further discussion at para 39 below). The Farmer Trustees will be three farmer representatives (a farmer directly elected by Supplying Shareholders, a director of Fonterra elected by Supplying Shareholders, and a member of the Fonterra Shareholders' Council). The discretionary beneficiaries of the trust will be Supplying Shareholders and Fonterra will be nominated as final beneficiary of the trust.

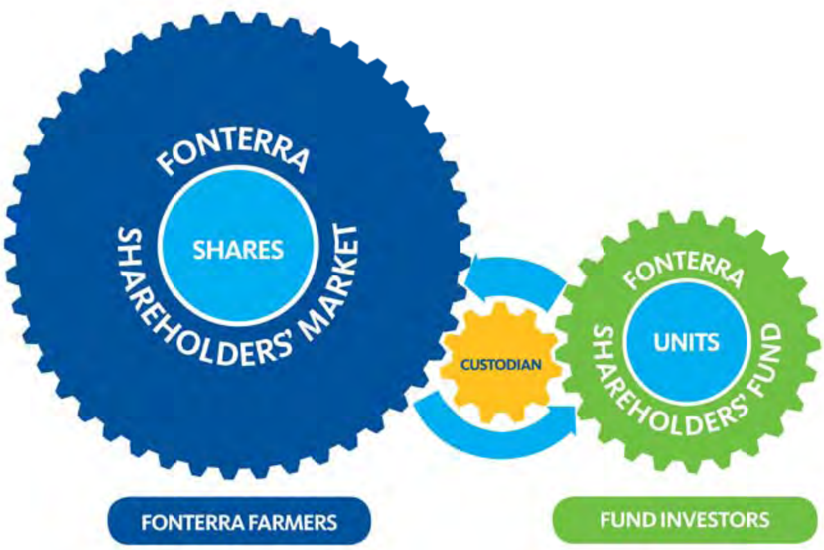
22. The Custodian (and the FSF) will not have any voting rights in Fonterra under Fonterra's Form B Constitution, which restricts voting rights to Supplying Shareholders (ie production based voting rights), except at a meeting of an interest group where there would otherwise be no shareholder entitled to vote at that meeting under clause 24.2(c) of the Form B Constitution. Under clause 7.8 of the Form B Constitution, the Authorised Fund Contract is required to prohibit the FSF and the Custodian from exercising, controlling or exerting any influence over any voting rights attached to the Shares. The Unit Trust Deed and Custody Trust Deed also contain provisions preventing the FSF and the Custodian from exercising any influence over voting rights attached to the Shares.

23. Under clause 7.1 of the Custody Trust Deed, the income of the Fonterra Economic Rights Trust includes amounts of deemed income that arise under tax law and the Custodian is permitted to distribute this income to the FSF.

24. At the time Fonterra pays any dividend to the Custodian and the Custodian distributes any dividend to the FSF as beneficiary income, the FSF will hold a valid "RWT exemption certificate" (as defined in s YA 1).

25. The following diagram summarises how the Arrangement operates, and highlights the relationship between the FSM and the FSF:

Overview of Trading Among Farmers



Operation of the FSF

26. The operation of the FSF is described in the paragraphs below.

27. Supplying Shareholders, RVPs and Fonterra can transfer economic rights in Shares to the FSF. In this context, "economic rights in Shares" means the rights to receive dividends and other benefits derived from a Share, including any change in value of the Share, as well as the other rights and benefits comprised in the Share. It does not include any right to hold the legal title to a Share or a security convertible to a Share, or to exercise production-based voting rights.

28. The process for selling economic rights in Shares to the FSF will involve two steps:

    a) Supplying Shareholders, RVPs, and Fonterra will transfer legal title to a Share to the Custodian (legal title to the Share will not pass to the FSF).

    b) The Custodian will hold the economic rights in the Shares on trust for the Unit Trustee.

29. The economic rights in Shares will be the FSF's only material asset. Under clause 7.5 of the Form B Constitution, the aggregate number of Shares in which the FSF may acquire economic rights is limited to 25 percent of the total number of Shares on issue (excluding treasury stock).[1] If this limit is exceeded the Board of Fonterra is obliged to take steps to bring the number of Shares placed with the FSF back within the limit within an appropriate timeframe (clause 7.6 of the Form B Constitution).

30. Units in the FSF will be issued by the Manager upon receipt of economic rights in a Share by the FSF. In addition, if Fonterra issues further Shares in respect of a Share held by the Custodian (in respect of which economic rights are being held in favour of the Unit Trustee), the FSF will issue a corresponding number of Units to its Unit Holders pursuant to clauses 15.1(d) and (e) of the Unit Trust Deed. This ensures that the number of Shares placed with the Custodian in which economic rights are being held in favour of the Unit Trustee will always equal the number of Units on issue. Clauses 15.1(a) and (b) of the Unit Trust Deed provide for the payment of cash dividends or other cash benefits to Unit Holders, mirroring payments on the Shares, as follows:

    (a) upon receipt of a cash dividend or other cash Benefits (other than a Supplementary Dividend) paid by Fonterra, this will be distributed to Unit Holders who were recorded in the Register at the same time and on the same record date as applied by Fonterra to determine the entitlement to the cash dividend or other cash Benefits. The amount to be paid or transferred to each such Unit Holder in respect of each Unit held by that Unit Holder as at that time, will be equal to the amount Fonterra paid or transferred per Share adjusted to take into account any Tax Liability of the Trust relating to the Unit Holder or any adjustments in accordance with s HM 48 of the Tax Act, and less any non-resident withholding tax deducted in respect of the Unit Holder in accordance with Subpart RF of the Tax Act pursuant to section HM 44B of the Tax Act and less any sum authorised in accordance with an

[1] It is proposed that this threshold be reduced from 25% to 20%.

Extraordinary Resolution pursuant to paragraph 11.1(b)(viii) of Schedule 1;

(b) upon receipt of any Supplementary Dividend paid by Fonterra, this will be distributed to the Unit Holders that entitled Fonterra to apply section LP 2 of the Tax Act and receive a tax credit for the Supplementary Dividend;

31. Each Supplying Shareholder or RVP who transfers Shares to the Custodian (in which economic rights have been sold to the FSF) will receive either one Unit in the FSF for each such economic right in a Share transferred or a cash sum (clause 5.1 of the Unit Trust Deed) in recognition of the transfer of the economic right in the Share to the FSF. Supplying Shareholders who sell economic rights in Shares to the FSF will also receive "vouchers" (subject to individual limits) that will count towards the share standard and support production-based voting rights and the right to full share backed milk price (clause 5.3 of the Unit Trust Deed).

32. Under the Unit Trust Deed, each Unit issued by the FSF will evidence the entitlement of the holder to the economic benefits (including distributions and other benefits) in the whole of the trust fund. As the number of Units issued by the FSF equals the number of Shares held by the Custodian (in which economic rights are being held in favour of the Trustee of the FSF), in effect each Unit will provide rights to receive the distributions and other benefits in respect of one Share. Individuals and their associates will be permitted to hold no more than 15% of the lesser of the total number of Units on issue or the total voting rights in the FSF under clause 6.1 of the Unit Trust Deed.

33. Clause 4.1(c) of the Unit Trust Deed sets out that the Units do not confer any interest in certain amounts under the Unit Trust Deed, as follows:

> (c) Unless the Manager directs otherwise, Units shall not confer any interest in interest income of the Trust or in monies paid to the Trustee or the Manager to meet their fees or to reimburse either of those parties for (or any advance payment in respect of) any expenses, liabilities, losses and costs incurred by them respectively in or about acting as Trustee or Manager (as the case may be) under this Deed. In all cases, all interest income and such monies will be applied by the Manager to meet the expenses, liabilities, losses and costs incurred by the Manager or the Trustee in or about acting as Manager or Trustee (as the case may be).

34. The FSF Units will trade on a registered market (ie, the NZSX) in which Supplying Shareholders, RVPs, Fonterra and other Public Investors may participate. Standard listing rules (but with various exemptions to those rules recognising that it is a unit trust and to accommodate other characteristics of the Trading Among Farmers proposal) will apply to the FSF. Fonterra and the FSF will co-operate with each other in relation to matters such as disclosure of information, to enable the FSF to comply with the listing rules applicable to the FSF.

35. Supplying Shareholders, RVPs and Fonterra will be able to exchange Units for Shares subject to various limits, but no other investor will be able to do this (clause 9 of the Unit Trust Deed). For example, if a Supplying Shareholder, Fonterra or an RVP wished to acquire a Share, it could do so by either buying a Share on the FSM, or by buying a Unit and presenting that Unit to the Unit Trustee for redemption and demanding that the Trustee procure the Custodian to transfer to it (or in the case of the RVP, to the Custodian to hold on trust for the RVP) one Share.

36. Under clauses 6.5 and 7.8 of the Form B Constitution and clause 15.2 of the Unit Trust Deed, neither the RVPs nor the FSF (or the Custodian in relation to either) is entitled to exercise any voting rights attached to Shares which are from time to time held for them by the Custodian (except on an interest group resolution where otherwise no shareholder can vote, clause 24.2(c) of the Form B Constitution).

37. Except as noted in para 35 above, no Unit Holder shall be entitled or permitted to require the transfer to that Unit Holder of any of the property of the FSF, or any Share. The Unit Trustee will covenant that it will not call for a transfer of the Shares (clause 4.8 of the Custody Trust Deed). In addition, no Unit Holder may redeem their Units for cash other than as described in clause 15.1(h) of the Unit Trust Deed. However, Unit Holders may sell their Units to other investors on the NZSX.

38. In addition to dividends, which are expected to be paid twice a year, other potential distributions in respect of the Shares include:

    (a) taxable and non-taxable bonus issues;

    (b) in-specie distributions of property;

    (c) share buy-backs;

    (d) dividend reinvestment schemes;

    (e) renounceable and non-renounceable rights issues; and

    (f) notional distributions.

39. The Farmer Trustees will hold one Unit in the FSF (the Fonterra Unit) which has special, essentially veto, rights (clauses 4.5 to 4.8 of the Unit Trust Deed). This will require the Farmer Trustees' approval, for example, to an amendment, removal or alteration of a provision of the Unit Trust Deed where that amendment, removal or alteration would change:

    (a) the governance structure of the Board of the Manager;

    (b) the scope and role of the trust fund;

    (c) the obligation of the trust to facilitate the exchange of a Share for a Unit or a Unit for a Share; or

    (d) the limit of 15% on the number of Units that can be held by any person or their associated persons (other than Fonterra or a wholly owned subsidiary of Fonterra); or

    (e) the terms of the Fonterra Unit.

40. The rights of the Fonterra Unit to proceeds and distributions from the FSF will be the same as for all other Units (clause 4.5(h) of the Unit Trust Deed).

41. Section 16 of the Dairy Industry Restructuring Amendment Act 2012 inserts a new section 161A and 161B into the DIRA to allow Fonterra to hold Units in the FSF. Fonterra will maintain a unitholding in the FSF so that it can manage the size of the FSF. Fonterra's unitholding may

increase or decrease depending on market activity, but it will always hold at least one Unit. In respect of Units held by Fonterra, the DIRA prevents Fonterra from exercising those voting rights carried by those Units (section 161A(i)).

42. The FSF may derive income other than from the Shares held by the Custodian on its behalf (Other Income) such as interest on cash held in a bank account. To the extent the Fund derives Other Income or there is assessable income from the Funding Arrangement, clause 4.1(c) of the Unit Trust Deed provides that no Unit Holder has an interest in such other income, unless the Manager directs otherwise. Any Other Income which is available to the FSF will be paid to the Unit Trustee as part of the fees due to the Unit Trustee.

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) The requirements of subs HM 55D(5), (6) and (7) and ss HM 55E and HM 55F are met.

b) The FSF is not treated under any double tax agreement as not being resident in New Zealand.

c) The FSF does not carry on the business of life insurance.

d) 90% or more of the FSF's investments (by value of its assets) are investments of a type referred to in s HM 11, other than an interest in land in New Zealand or a right or option in relation to land in New Zealand, in accordance with s HM 19C(1).

e) 90% or more of the income derived by the FSF is of a type referred to in s HM 12, other than an amount derived from an interest in land in New Zealand or the disposal of an interest in land in New Zealand, in accordance with s HM 19C(2).

f) The FSF does not calculate its income tax liability using the provisional tax calculation option in s HM 44.

g) The FSF has not lost its PIE status through the application of ss HM 25, HM 27 and/or HM 29.

How the Taxation Laws apply to the Arrangement

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

a) Following its establishment, the FSF will qualify as a "foreign investment variable-rate PIE" (as defined in s YA 1).

b) The FSF's interest in the Shares is an investment of a type referred to in s HM 11.

c) Income derived by the FSF from its interest in the Shares is income of a type referred to in s HM 12.

d) Income attributed by the FSF to its investors will be “excluded income” (as defined in s BD 1(3)) of the investor under s CX 56(3) provided that:

- o The requirements in ss CX 56(1) and/or CX 56(1B) are met; and
- o The amount is not an amount of attributed PIE income that is derived by a trustee who has chosen a prescribed investor rate referred to in sch 6, table 1, row 5 or 7, as applicable; and
- o The investor is not a person to whom s HM 57B would have applied but who has chosen not to apply that section to determine their prescribed investor rate for a “resident year” (as defined in s HM 57B(3)).

e) Where a Share is transferred to a Unit Holder on redemption of their Unit, that Unit Holder will be treated as acquiring that share for its market value to the FSF on the date of transfer under s FC 2.

f) Any redemption proceeds a Unit Holder receives as a result of the FSF redeeming a Unit (including a distribution of a Share) that are income, will be excluded income of the Unit Holder under s CX 56B.

g) Any distributions from the FSF will be excluded income of each Unit Holder under s CX 56B (and therefore not taxable), other than where the FSF elects to pay non-resident withholding tax in accordance with s HM 44B in respect of the distribution.

h) The Arrangement is not subject to s BG 1.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 25 October 2012 and ending on 30 November 2015.

This Ruling is signed by me on the 25th day of October 2012.

Fiona Heiford
Manager (Taxpayer Rulings)