

TR 93/D29 - Income tax: cotton growers - trading stock and derivation of income under various selling options



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Draft Taxation Ruling

Income tax: cotton growers - trading stock and derivation of income under various selling options

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What this Ruling is about

1. This Ruling provides guidelines on -
 - (i) the application of the trading stock provisions of the Income Tax Assessment Act 1936 (the Act) to harvested cotton (seed cotton) which is the subject of a cotton purchase contract or pool marketing agreement between the cotton grower and a cotton merchant. In this regard, this Ruling supersedes Ruling IT 2150 which is now withdrawn. In many instances, but not always the case, the cotton merchant will also be the processor (ie. responsible for ginning) of the seed cotton;
 - (ii) the point in time when income is derived by a cotton grower for the purposes of Section 25(1) of the Act under the various cash purchase contracts or pool marketing agreements that are offered by cotton merchants to growers.

Ruling

A. Trading Stock

2. Modules of seed cotton subject to a cotton or pool marketing agreement with a cotton merchant become the property of the merchant, and are trading stock of the merchant for the purposes of the Act, at the time the module ticket has been accepted by that merchant (or as specified in the cotton purchase contract or pool marketing agreement) irrespective of whether that occurs on delivery of the

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module, or prior to that time. Otherwise the power to dispose of the property remains with the grower and is trading stock of the grower for the purposes of the Act.

3. Bales of raw cotton produced from modules of seed cotton not subject to a cotton purchase contract or pool marketing agreement remain trading stock of the grower for the purposes of the Act. Bales of raw cotton produced from modules of seed cotton the subject of a cotton purchase contract or pool marketing agreement with the merchant are trading stock of the merchant. Bales of raw cotton (for which title has not passed at the module stage) which are subject to a cotton purchase contract or pool marketing agreement with a merchant are trading stock of the merchant upon delivery to the merchant.

4. Cottonseed (which is a by-product from the processing of seed cotton) produced from modules of seed cotton subject to pooling arrangements, whether property remains with the grower or has been transferred to a merchant under a cotton purchase contract or pool marketing agreement, will be accepted as coming within the terms of the decision of the High Court in *Farnsworth v FC of T* (1949) 78 CLR 504, 4 AITR 258, 9 ATD 33. This means that cottonseed subject to pooling arrangements extracted from seed cotton prior to balance date will not be trading stock on hand of the grower for the purposes of Section 28 of the Act.

5. It will also be the case under a pooling arrangement that where property in the cottonseed remains with the grower, the cottonseed will not be trading stock of the merchant for the purposes of Section 28 of the Act. However where the property in cottonseed subject to a pooling arrangement has been transferred to a merchant under a cotton purchase contract or pool marketing agreement, it will become trading stock in the hands of the merchant.

6. Cottonseed retained by a grower or transferred to a merchant which is not subject to pooling arrangements is trading stock on hand of the grower or merchant respectively for Section 28 purposes.

7. Where harvested seed cotton, raw cotton, or cottonseed is trading stock of the grower for the purposes of Section 28, the value of this trading stock on hand at the end of the year of income must be brought to account by the grower. Absorption cost is the correct method to use where the grower chooses to value trading stock at cost.

B. Derivation of Income by Cotton Growers

8. In accordance with well established principles, income is not derived by a grower until property has passed to the merchant and a debt for an ascertainable sum has been created. (*Farnsworth v FCT* (supra), *J. Rowe & Son Pty Ltd v FCT* (1971) 124 CLR 421; *FCT v*

Australian Gas Light Co & Anor 83 ATC 4800 at p.4805; *Dawson v Botten* (1952) 10 ATD 252). A final price cannot be ascertained and a debt created until all the variables affecting the price have been fixed.

(a) Pool Contracts

9. Pool contracts provide when a debt will become due and owing by the merchant to a grower. The merchant will usually strike a successive series of payments under a pool arrangement.

(i) Seasonal Pools

Distributions of seasonal pool proceeds are income in the growers hands at the time the pools have been determined and finalised. This is the date when the merchant determines the net price per kilogram (or pound) for the pool to be distributed to growers. This will usually be a short time prior to the date the grower actually receives payment, allowing for processing and mailing time. If a merchant makes a non-repayable advance distribution (whether or not at the request of a grower) the distribution is income of the grower in the income year in which the distribution is declared or approved by the merchant. Similarly, this will be a short time prior to the date when payment is received by or credited to the account of the grower.

Note: When making a payment, merchants should notify a grower of the date when the relevant determination or declaration was made.

(ii) On-Call Marketing Arrangements (On-Call Pools)

On-call arrangements (on-call pools) as described in paragraph 24 are generally treated in the same manner as seasonal pools for income tax purposes. Distributions of pool proceeds are income in the growers hands at the time the pools have been determined and finalised. If a merchant makes a non-repayable advance distribution (whether or not at the request of a grower) the distribution is income of the grower in the income year in which the advance distribution is declared or approved by the merchant.

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(iii) Fixed Price Marketing Arrangements (Fixed Price Pools)

Income is derived by growers at the time of determination of the value of the contract. It is understood that determination occurs at the time of classing, which is completed within 14 days of ginning.

(iv) Guaranteed Minimum Price Marketing Arrangements (Guaranteed Minimum Price Pools)

The guaranteed minimum price is income in the grower's hands at the time of classing, which is completed within 14 days of ginning. If payments are made in excess of the minimum price, these are assessable to the grower when declared by the merchant.

(b) Cash Purchase Contracts

10. Proceeds from cash purchase contracts become income in the grower's hands at the time of determination of the value of the contract. It is understood that determination occurs at the time of classing, which is within 14 days of ginning.

(c) Grower Loans

11. Grower loans which are made available by the merchants to growers on a commercial basis (ie. repayable, interest bearing and at commercial rates) are not income derived by the growers. However, if these requirements are not satisfied, the payments will be treated as assessable advance distributions at the time approved by the merchant.

Date of effect

12. This Ruling applies to years commencing both before and after its date of issue. 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 Taxation Ruling TR 92/20).

Explanations

13. In the cotton industry the cotton "processor" and the cotton "merchant" with respect to purchase, pool marketing and ginning contracts entered into with growers, are often the same corporate entity. This means that a ginning contract and a purchase contract or pool marketing agreement may be undertaken with the same corporate entity by a cotton grower. For the purposes of this Ruling, the corporate entity is generally referred to as the "merchant".

14. However, it is also common for a grower to have the harvested cotton (seed cotton) ginned by a processor that does not have the cotton purchase contract or pool marketing agreement with respect to the processed (raw) cotton. This may be with another cotton merchant that can also be a processor (ginner) in its own right.

A. The commodity

15. Harvesting of seed cotton commences as early as March and ends as late as November. As the seed cotton is harvested it is usually compressed into modules ready for transport from the farm to the cotton gin. The modules of seed cotton are delivered from time to time to a processor under the terms of a cotton ginning or ginning and cotton purchase contract/pool marketing agreement ("ginning" being the term used for the processing of seed cotton).

16. Each grower enters into a ginning contract with a processor irrespective of whether the grower retains title to the ginned cotton or passes title to a cotton merchant. In some cases the agreement between the grower and the processor will only be for ginning the seed cotton with title remaining with the grower. In those cases, the grower may enter into a contract with a merchant for the sale of the processed cotton (hereinafter called raw cotton) and the cottonseed. (In most cases only the raw cotton is sold to or marketed with the merchant with the cottonseed remaining with the grower or being sold to the processor-merchant). In other cases the grower will enter into a cotton purchase contract or pool marketing agreement with a processor-merchant covering both the ginning of seed cotton and the sale of raw cotton and cottonseed. The processor makes a ginning charge in accordance with the particular contract.

17. Ginning involves the separation of seed cotton into cottonseed and raw cotton and the cleaning and baling of the raw cotton. The cottonseed is usually pooled and sold to seed oil producers and merchants. (Some growers do, however, retain possession of their cottonseed entitlement). The cottonseed from all growers is inextricably mixed together following ginning and entitlements to

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income from that cottonseed are generally calculated by reference to the weight of raw cotton produced by each grower. The only rare exception to this general rule is where a grower is able to receive his own cottonseed by having cottonseed deposited directly into the grower's vehicle during the ginning process.

18. The raw cotton is baled and sold. Growers who do not enter into cash purchase contracts (or derivatives thereof) participate in the proceeds of the sale of raw cotton on a pool basis. Traditional pool marketing agreement alternatives available to growers from the processor-merchants or independent merchants are seasonal pool and on-call pool contracts. Fixed price agreements and guaranteed minimum price agreements are not traditional pool marketing agreements, as they are more akin to cash purchase contracts.

19. When the seed cotton is ginned and the raw cotton baled, a bale number is allocated to the bale. These bales are then removed to warehouses owned by the processor-merchant, independent merchants or third parties. The bales of purchased or pooled cotton are sold by the processor-merchant or independent merchant under the terms of the cotton purchase contract or pool marketing agreement. For traditional pool marketing agreements, although the bales or raw cotton can still be identified by their numbered tags as cotton of a particular grower, because of the pool marketing system applied in respect of the sale of cotton (vide *Farnsworth v FCT* (supra)), the grower participates in the distribution of the proceeds of the pool rather than receiving the proceeds of sale of their specific bales of raw cotton.

20. Typically a grower will enter into a seed cotton or raw cotton purchase contract or pool marketing agreement with the processor-merchant or independent merchant at an early stage in the growing season or even before the growing season, although in other cases the contract may be entered into after harvest. Delivery will normally occur upon acceptance by the purchaser of the module ticket, or by delivery of the baled cotton, or as specified in the cotton purchase contract or pool marketing agreement.

B. Selling Alternatives

(a) Seasonal Pools

21. The traditional form of pool marketing by growers was to deliver their seed cotton to a statutory authority or other processor-merchant which would pool both the raw cotton and the cottonseed. Early distributions from the pools were received by the growers in respect of both raw cotton and cottonseed pools and final distributions were made once the season's returns had been finalised.

22. Pools are now not only run by the traditional processor-merchants but are also run by some independent merchants (for the raw cotton only).

23. Essential features of pooled raw cotton and cottonseed marketing agreements are -

- (i) title in seed cotton passes from the grower to the cotton merchant upon delivery. Delivery is normally regarded as being effected upon the acceptance by the processor of a module ticket (or as specified in the cotton purchase contract or pool marketing agreement), which often occurs while the cotton is still on the grower's premises. Title in bales of raw cotton (for which title has not passed at module stage) which are subject to a cotton purchase contract or pool marketing agreement with a merchant, passes on delivery to the merchant, or as specified in the contract/agreement.
- (ii) bales of raw cotton and cottonseed produced from the seed cotton are pooled with other raw cotton and cottonseed.
- (iii) the merchant determines each grower's percentage interest in a pool in accordance with the terms of the pool marketing agreement (principally according to weight and grade).
- (iv) in determining the value of the seasonal pool the merchants operating the raw cotton and cottonseed pools are inter alia authorised to sell and deliver the raw cotton and cottonseed produced to third parties, enter into cotton futures contracts and currency hedging contracts or option contracts related thereto on terms and conditions determined by the respective merchant.
- (v) the normal terms and conditions under seasonal pool marketing agreements state that proceeds for raw cotton or cottonseed are not available until the pools have been determined and finalised. Merchants may make distributions from the pool prior to the finalisation of the pool.
- (vi) after all the cotton in the pool has been sold, deductions are made for transport and storage costs and also ginning costs (where the merchant is also the processor) for all the cotton in the pool in determining the final amount available for distribution to growers.

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- (vii) where the merchant is not the processor, the raw cotton is normally delivered to or collected by the merchant from the gin within 10 days of ginning.
- (viii) a sample of cotton is taken from each bale of raw cotton at the time of ginning and forwarded to the merchant or nominated classing organisation. This sample is then used to determine the grade of the bale.

(b) On-Call Marketing Arrangements (On Call Pools)

24. A grower may elect to market his cotton through an "on-call pool" whereby the grower is able to instruct the merchant to enter into cotton futures and currency hedging contracts for the grower's benefit. Under certain arrangements the cotton and currency hedge values plus the "basis" are the essential components for calculating the amount the grower will receive under the agreement once the pool has been determined and finalised, or as otherwise determined by the terms of the contract. ("Basis" is the difference between the cotton futures contract price achieved and the cash price that the merchant is able to sell the cotton for in the world market.)

25. In many cases a grower using an on-call pool will know the gross sale proceeds some time prior to the pool being finalised. However as the deduction for transport and storage costs (a variable amount but representing a significant proportion of the gross sale price) for the pool cannot be ascertained until the pool is finalised, no debt can be established until then.

(c) Cash Purchase Contracts

26. Cash purchase contracts have now become a common method of selling raw cotton by a grower. The purchaser could be any one of the merchants whether a processor-merchant or an independent merchant. The agreement may be entered into well before harvest and ginning or well after harvest and ginning.

27. The essential features of a cash purchase contract are -

- (i) an agreement is made between the grower and merchant on a price per kg or price per pound in Australian Dollars (AUD) or United States Dollars (USD). This price is based on a standard grade of cotton and is subject to a discount/premium based on actual grade of cotton produced.

- (ii) where the merchant is not the processor, the raw cotton is normally delivered to or collected by the merchant from the gin within 10 days of ginning.
- (iii) a sample of cotton is taken from each bale of raw cotton at the time of ginning and forwarded to the merchant or nominated classing organisation. This sample is then used to determine the grade of the bale after which the value of the raw cotton is able to be determined.
- (iv) full payment is normally made to the grower by the merchant on an agreed number of days after ginning. It is accepted by the industry that 14 days is an adequate time for the merchant to take delivery of the samples and bales and arrange for the classing tests to determine the value of the raw cotton.

(d) Fixed Price Marketing Arrangements (Fixed Price Pools)

28. These are similar to cash purchase contracts in that the merchants guarantee the return to the grower subject to normal grade and other quality variables.

(e) Guaranteed Minimum Price Marketing Arrangements (Guaranteed Minimum Price Pools)

29. A few merchants also offer guaranteed minimum price arrangements. These are similar to cash purchase contracts in that a minimum price (subject to quality discount/premium) is guaranteed under the terms of the contract. A debt in relation to the minimum price is created with the grower under these contracts within 14 days of ginning. Further payments in excess of the guaranteed minimum price may be made to growers, but this is at the total discretion of the merchant.

C. Grower Loans

30. Due to the time lag between sowing the crop, harvesting the crop and receiving payment for the crop, many growers need working capital to finance the next year's operation and/or repay borrowings received from other financiers. Growers commonly have the facility to borrow from the merchant using their crops or cotton as security for these borrowings.

31. The sophisticated Treasury functions of the merchants, and relevant State legislation, enable the merchants in some States to act as financiers in funding grower operations. In competing for a grower's

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business a particular merchant may be able to offer reduced borrowing charges, competitive lending rates and more favourable repayment terms.

32. The grower's debt would be made up of the loan principal plus interest to the date of repayment. As the grower becomes entitled to cotton proceeds and a debt becomes owing by the merchant to the grower there is usually an agreement that these proceeds are applied to discharge the grower's debt to the merchant.

33. The lending function is not to be confused with an advance distribution of income to growers as permitted under the terms of some cotton purchase contracts/pool marketing agreements entered into with merchants. Loans are distinguishable by being repayable, interest bearing, at commercial rates and at the discretion of the grower.

D. Trading Stock Valuation

34. Harvested seed cotton (usually in the form of modules) for which the module ticket has not yet been accepted by the merchant is trading stock of the grower. Raw cotton not subject to a cotton purchase contract or pool marketing agreement and cottonseed not subject to a pooling arrangement will also be trading stock of the grower. Section 31 of the Act provides that the grower shall have the option of valuing trading stock on hand at the end of a year of income at cost price, market selling value or replacement price.

35. Absorption cost is the correct method to use where the grower elects to use cost price (*Philip Morris v. FC of T* 79 ATC 4350; 10 ATR 44). This will include not only the costs of planting, tending and harvesting the crop but also an appropriate portion of overheads. For raw cotton and cottonseed, processing costs would also be included. Although the *Philip Morris Case* related to manufactured goods, the principle also applies to primary producers, subject to the proviso that for primary producers trading stock does not come into existence until the produce is harvested.

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case references

- FC of T v. Australian Gas Light Co.
83 ATC 4800; (1983) 15 ATR 105
- Dawson v. Botton (1953) 10 ATD
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- J Rowe & Son Pty Ltd v. FC of T
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- Philip Morris Ltd v. FC of T
79 ATC 4350; (1979) 10 ATR 44