



Class Ruling

Income tax: statutory licence roll-over for the replacement of existing water entitlements with new water entitlements under the *Water Act 1989* (Victoria)

Contents	Para
LEGALLY BINDING SECTION:	
What this Ruling is about	1
Date of effect	9
Scheme	14
Ruling	20
NOT LEGALLY BINDING SECTION:	
Appendix 1:	
Explanation	27
Appendix 2:	
Detailed contents list	55

① This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 15-10 of the ITAA 1997;
 - section 15-15 of the ITAA 1997;
 - section 104-25 of the ITAA 1997;
 - section 108-5 of the ITAA 1997; and
 - Subdivision 124-C of the ITAA 1997.

All legislative references in the Ruling are to the ITAA 1997 unless otherwise indicated.

Class of entities

3. The class of entities to which this Ruling applies is entities who hold existing water entitlements under the *Water Act 1989* (Victoria), which end (or will end) and are replaced with new water entitlements (including water shares, water-use registrations, water-licences, delivery entitlements and works licences) by the *Water (Resource Management) Act 2005* (Victoria).

4. The class of entities referred to in paragraph 3 of this Ruling does not include entities that carry on a business of trading in water entitlements.

Qualifications

5. The Commissioner makes this Ruling based on the precise scheme identified in this Ruling.

6. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 14 to 19 of this Ruling.

7. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

9. This Ruling applies from 1 July 2006 to 30 June 2010. However, the Ruling continues to apply after 30 June 2010 to all entities within the specified class who entered into the specified scheme during the term of this Ruling.

10. This Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

11. If this Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

12. If this Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

13. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Scheme

14. The following description of the scheme is based on information provided by the applicant. The following documents, or relevant parts of them, form part of and are to be read with the description:

- request for Class Ruling by Blake Dawson Waldron on behalf of the Department of Sustainability & Environment (DSE) (Victoria) dated 22 December 2006;
- *Water Act 1989* (Victoria) (Water Act);
- *Water (Resource Management) Act 2005* (Victoria) (Water Resource Management Act) which came into effect on 21 December 2006; and
- correspondence and e-mails received in relation to the application for a class ruling.

15. The intergovernmental National Water Initiative (NWI) was agreed to by the Commonwealth and State Governments in June 2004. One of the objectives of the NWI is 'the return of all currently over-allocated or overused systems to environmentally sustainable levels of extractions'.¹

16. The Water Resource Management Act amends the Water Act to achieve reform of water markets and to implement the NWI. An essential element of the reform is to provide for the ending of a range of existing statutory water entitlements (original water entitlements) and replacement with new statutory water entitlements (water shares, water-use licences, water-use registrations, delivery entitlements and works licences).

17. Section 71 of the Water Resource Management Act introduces Schedule 15 into the Water Act. Schedule 15 deals with the ending and replacement of original entitlements with new entitlements. Schedule 15 and other amendments to the Water Act by the Water Resource Management Act provide that on and from the day a water system is declared, the original entitlements in relation to that water system end and holders of those entitlements are deemed to be the owners of new entitlements as indicated in the following table.

Original entitlement	New entitlement	Converting clause in Schedule 15
Take and use licences under section 51	• water share • water-use licence • works licence • in respect of a prior 222(1)(d) sales water agreement, a water share with the same volume as in the sales water agreement immediately prior to the declaration of the water system	Clauses 13 and 14

¹ See clause 23 of the 'Intergovernmental Agreement on a National Water Initiative' signed on 25 June 2004.

Domestic and stock allowances under former paragraph 222(1)(a)	• water share • water-use registration • delivery entitlement • in respect of a prior 222(1)(c) sales water agreement, a water share with the same volume as in the sales water agreement immediately prior to the declaration of the water system	Clauses 6 and 7
Water rights under former paragraph 222(1)(b)	• water share • water-use licence • delivery entitlement • in respect of a prior 222(1)(c) sales water agreement, a water share with the same volume as in the sales water agreement immediately prior to the declaration of the water system	Clauses 5 and 7
Domestic and stock right together with a water right (Joint right) under subsection 222(1)	• water share • water-use licence • delivery entitlement • in respect of a prior 222(1)(c) sales water agreement, a water share with the same volume as in the sales water agreement immediately prior to the declaration of the water system	Clauses 4 and 7

18. The declaration of water systems commenced from 1 July 2007 and will be completed by 30 June 2010.

19. Owners of original water entitlements will not receive any non-licence proceeds (ineligible proceeds) in addition to the new water entitlements for the ending of the original entitlements.

Ruling

Section 6-5 – income according to ordinary concepts

20. The replacement of the original water entitlements with new water entitlements pursuant to Schedule 15 of the Water Act will not give rise to assessable ordinary income under section 6-5.

Section 15-10 – bounty or subsidy

21. The replacement of the original water entitlements with new water entitlements pursuant to Schedule 15 of the Water Act will not give rise to assessable income under section 15-10.

Section 15-15 – profit-making undertaking or plan

22. The replacement of the original water entitlements with new water entitlements pursuant to Schedule 15 of the Water Act will not give rise to assessable income under section 15-15.

Capital gains tax

23. The original water entitlements and the new water entitlements are statutory licences and are CGT assets under section 108-5.

24. CGT event C2 under section 104-25 happens when an original water entitlement under the Water Act ends.

25. The capital proceeds from CGT event C2 happening to each original water entitlement are the total of the market values of the new water entitlements (water shares, water-use licences, water-use registrations, delivery entitlements and works licences).

26. Roll-over relief under Subdivision 124-C applies for entities who own an original water entitlement which ends and is replaced by new water entitlements pursuant to Schedule 15 of the Water Act, provided that the new entitlements are received by the same entities who owned the original entitlement and in the same shares.

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Section 6-5 – income according to ordinary concepts

27. Subsection 6-5(1) provides that an amount is included in assessable income if it is income according to ordinary concepts (ordinary income). However, as there is no definition of 'ordinary income' in the income tax legislation it is necessary to apply principles developed by the courts to the facts of a particular case.

28. Whether or not a particular receipt is ordinary income depends on its character in the hands of the recipient.²

29. In *GP International Pipecoaters Pty Ltd v. Federal Commissioner of Taxation*,³ the Full High Court stated at CLR 138; ATR 7; ATC 4420:

To determine whether a receipt is of an income or of a capital nature, various factors may be 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.

30. The original water entitlements are valuable assets that are capital in nature. The effect of Schedule 15 of the Water Act and the other amendments to that Act made by the Water Resource Management Act is that, upon the declaration of a water system, the original water entitlements in relation to that water system end and the holder of the original water entitlement is deemed to own new water entitlements as set out in paragraph 17 of this Ruling. The replacement of the original water entitlements with new water entitlements pursuant to Schedule 15 of the Water Act is capital in nature, and thus, will not give rise to assessable ordinary income under section 6-5.

² *Scott v. Federal Commissioner of Taxation* (1966) 117 CLR 514, *Hayes v. Federal Commissioner of Taxation* (1956) 96 CLR 47, *Federal Coke Co Pty Ltd v. Federal Commissioner of Taxation* (1977) 7 ATR 519; 77 ATC 4255.

³ (1990) 170 CLR 124; (1990) 21 ATR 1; 90 ATC 4413.

Section 15-10 – bounty or subsidy

31. Section 15-10 includes in assessable income bounties and subsidies that are received in relation to carrying on a business and that are otherwise not assessable as ordinary income. The basic tests contained in section 15-10 are that an amount is assessable income if it is:

- a bounty or subsidy;
- received in relation to carrying on a business; and
- not assessable as ordinary income under section 6-5.

32. The terms 'bounty' and 'subsidy' are not defined in income tax legislation. The word 'subsidy', as noted by Windeyer J in *Placer Development Ltd v. Commonwealth of Australia*,⁴ derives from the Latin 'subsidium' meaning 'an aid or help'. The Macquarie Dictionary, 2001, rev. 3rd edn, defines subsidy as including 'a grant or contribution of money'. The ordinary meaning adopted by case law is aid provided by the Crown (government) to foster or further some undertaking or industry.

33. A bounty or subsidy will be 'in relation to' carrying on a business when there is a real connection between the payment and the business. The term 'in relation to' includes within its scope payments that have a direct or indirect connection to the business. As stated by Hill J in *First Provincial Building Society v. FC of T* (1995) 56 FCR 320 at 332:

The words 'in relation to' are words of wide import. They are capable of referring to any relationship between the two subject matters, in the present case the receipt of the bounty or subsidy, on the one hand, and the carrying on of the business, on the other ... the degree of connection will be 'a matter of judgment on the facts of each case'. ...What is necessary, at the least, in the present context is that there be a real connection ... the relationship need not be direct, it may also be indirect.

34. A bounty or subsidy must be related to 'carrying on' the business not merely for commencing or ceasing a business. As stated by Hill J in *First Provincial Building Society v. FC of T* (1995) 56 FCR 320 at 332:

the relationship must be to the 'carrying on' of the business. These words may perhaps be understood in opposition to a relationship with the actual business itself. They would make it clear, for example that a bounty received, merely in relation to the commencement of a business or the cessation of the business, would not be caught. The expression 'carrying on of a business' looks, in my opinion, to the activities of that business which are directed towards the gaining or producing of assessable income, rather than merely to the business itself.

⁴ (1969) 121 CLR 353.

35. The replacement of the original water entitlements with new water entitlements pursuant to Schedule 15 of the Water Act does not constitute a bounty or subsidy received in relation to carrying on a business and will not give rise to assessable income under section 15-10 of the ITAA 1997.

Section 15-15 – profit-making undertaking or plan

36. Section 15-15 includes in assessable income profit arising from the carrying on or carrying out of a profit-making undertaking or plan. However, section 15-15 does not apply to a profit that is assessable as ordinary income under section 6-5 or arises in respect of the sale of property acquired on or after 20 September 1985.

37. The replacement of the original water entitlements with new water entitlements is the result of the amendment of the Water Act in order to reform water markets and to implement the National Water Initiative, adopted by the Council of Australian Governments in 2004. The replacement did not arise from the carrying on or carrying out of a profit-making undertaking or plan. Therefore, the replacement of the original water entitlements with new water entitlements pursuant to Schedule 15 of the Water Act will not give rise to assessable income under section 15-15.

Capital gains tax

38. Section 104-25 provides that CGT event C2 happens if a CGT asset you own ends in one of a number of ways, including its cancellation or expiry.

39. A CGT asset is defined in subsection 108-5(1) as:

- any kind of property; or
- a legal or equitable right that is not property.

40. The original entitlements under the former subsection 222(1) and section 51 of the Water Act entitle their owners to take water subject to the specifications applicable to the licence. They are statutory rights and, therefore, they are CGT assets within the definition of a CGT asset under subsection 108-5(1).

41. Accordingly, CGT event C2 happens when the original water entitlement comes to an end. This will be at the time that a water system is declared which results in the original entitlements in relation to that water system ending and being replaced with new water entitlements.

42. A capital gain is made from CGT event C2 if the capital proceeds from the ending of a CGT asset exceed the asset's cost base. A capital loss is made if the capital proceeds from the ending of the CGT asset are less than the asset's reduced cost base (subsection 104-25(3)).

43. The capital proceeds from a CGT event are the total of the money you receive, or are entitled to receive and the market value of any property you have received or are entitled to receive, in respect of the event happening (subsection 116-20(1)).

44. The capital proceeds from CGT event C2 happening to an original entitlement is the total of the market value of the new water entitlements including water shares, water-use licences, water-use registrations, delivery entitlements and works licences.

Statutory licence roll-over

45. Section 124-140 provides that there is roll-over if:

- your ownership of one or more statutory licences ends and CGT event C2 happens;
- as a result of the ending of the original licence(s), you are issued with one or more new licences, and
- the new licence authorises substantially similar activity as that authorised by the original.

46. An original water entitlement is a statutory licence for the purposes of subsection 124-140(3).

47. Where owners of an original water entitlement receive new water entitlements, the ending of the original water entitlement satisfies the requirements of paragraph 124-140(1)(a).

48. Paragraph 124-140(1)(b) provides that roll-over only applies if you get a new licence(s) for the original licence. The issue of new water entitlements under the Water Resource Management Act satisfies this requirement.

49. Paragraph 124-140(1)(c) provides that the new licence must authorise substantially similar activity as that authorised by the original licence. Where owners of an original water entitlement receive new water entitlements under the Water Resource Management Act as a result of a water system being declared, the new water entitlements authorise the same activity as the original water entitlements, being access to water. Therefore, the requirements of the provision are met and rollover relief under Subdivision 124-C applies.

Consequences of roll-over

50. A capital gain or loss that a licence owner makes because of the ending of their original water entitlement is disregarded to the extent that a replacement water entitlement is received (section 124-145).

51. The first element of the cost base (or reduced cost base) of the new water entitlements is such amount as is reasonable having regard to:

- the total cost bases of all the original water entitlements;
- the number, market value and character of the original water entitlements; and
- the number, market value and character of the new water entitlements (subsections 124-155(2) and 124-155(3)).

52. A new water entitlement (including water shares, water-use licences, water-use registrations, delivery entitlements and works licences) is taken to have been acquired before 20 September 1985 if the original water entitlement was acquired before that date (section 124-160).

53. If there was more than one original water entitlement and one or more of them was acquired before 20 September 1985 and one or more after that date, each new water entitlement is taken to be two separate assets. One asset represents the extent to which the original water entitlement was acquired before 20 September 1985 and is taken to have been acquired before that date (section 124-165).

54. The other asset represents the extent to which the original water entitlement was acquired on or after 20 September 1985 and is taken to have been acquired on or after that date (subsection 124-165(2)(a)). The first element of the cost base (or reduced cost base) of this asset is worked out under subsection 124-165(3).

Appendix 2 – Detailed contents list

55. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Relevant provision(s)	2
Class of entities	3
Qualifications	5
Date of effect	9
Scheme	14
Ruling	20
Section 6-5 – income according to ordinary concepts	20
Section 15-10 – bounty or subsidy	21
Section 15-15 – profit-making undertaking or plan	22
Capital gains tax	23
Appendix 1 – Explanation	27
Section 6-5 – income according to ordinary concepts	27
Section 15-10 – bounty or subsidy	31
Section 15-15 – profit-making undertaking or plan	36
Capital gains tax	38
<i>Statutory licence roll-over</i>	45
<i>Consequences of roll-over</i>	50
Appendix 2 –Detailed contents list	55

References

Previous draft:

Not previously issued as a draft

Subject references:

- capital gains tax
- ordinary income
- profit-making undertaking or plan

Legislative references:

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- ITAA 1997 6-5(1)
- ITAA 1997 15-10
- ITAA 1997 15-15
- ITAA 1997 104-24(1)
- ITAA 1997 104-25
- ITAA 1997 104-25(3)
- ITAA 1997 108-5
- ITAA 1997 108-5(1)
- ITAA 1997 116-20(1)
- ITAA 1997 Subdiv 124-C
- ITAA 1997 124-140
- ITAA 1997 124-140(1)(a)
- ITAA 1997 124-140(1)(b)
- ITAA 1997 124-140(1)(c)
- ITAA 1997 124-140(3)
- ITAA 1997 124-145
- ITAA 1997 124-155(2)
- ITAA 1997 124-155(3)
- ITAA 1997 124-160
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- ITAA 1997 124-165(1)(a)
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- 222(1)(d)
- Water Act 1989 (Victoria) Sch 1
- Water (Resource Management) Act 2005 (Victoria)
- Water (Resource Management) Act 2005 (Victoria) 71

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- Federal Coke Co Pty Ltd v. Federal Commissioner of Taxation (1977) 34 FLR 375; (1977) 7 ATR 519; 77 ATC 4255
- First Provincial Building Society v. Federal Commissioner of Taxation (1995) 56 FCR 320
- GP International Pipecoaters Pty Ltd v. Federal Commissioner of Taxation (1990) 170 CLR 124; (1990) 21 ATR 1; 90 ATC 4413
- Placer Development Ltd v. Commonwealth of Australia (1969) 121 CLR 353
- Scott v. Federal Commissioner of Taxation (1966) 117 CLR 514

Other references:

- Macquarie Dictionary, 2001, rev 3rd edn
- Intergovernmental Agreement on a National Water Initiative signed on 25 June 2004

ATO references

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