



Class Ruling

Income tax: St George channel scheme – receipt of membership interests in Mallawa Irrigation Limited

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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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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.

Summary – what this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) 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 6-10 of the ITAA 1997
- section 15-10 of the ITAA 1997
- section 110-25 of the ITAA 1997
- section 112-20 of the ITAA 1997
- section 21A of the *Income Tax Assessment Act 1936* (ITAA 1936).

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

Class of entities

3. The class of entities to which this Ruling applies is residents of Australia who:

- received a membership interest in Mallawa Irrigation Limited (Mallawa Irrigation) on 1 July 2018 (the Transfer Day), and
- are not subject to the taxation of financial arrangements rules in Division 230 of the ITAA 1997 in relation to gains or losses on their membership interests in Mallawa Irrigation.

(Note: Division 230 of the ITAA 1997 will generally not apply to individuals, unless they have made an election for it to apply to them.)

In this ruling, an entity belonging to this class of entities is referred to as a 'Member'.

Qualifications

4. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is in accordance with the scheme described in paragraphs 7 to 28 of this Ruling.

5. 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.

Date of effect

6. This Ruling applies from 1 July 2017 to 30 June 2019. The Ruling continues to apply after 30 June 2019 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will 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 this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Scheme

7. The following description of the scheme is based on information provided by the applicant.

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

8. The St George channel scheme is the system used to supply water under water allocations to irrigators who purchase irrigation services in the St George water supply scheme.

9. SunWater Limited (Sunwater) is a Queensland government owned corporation which is a bulk water infrastructure developer and manager, owning and operating a number of channel irrigation schemes throughout Queensland.

10. In 2012, the Department of Natural Resources, Mines and Energy (DNRME), established a project to consider the transition of channel irrigation schemes, including the St George channel scheme, to local management arrangements.

11. Chapter 4A of the *Water Act 2000* (Qld) provides for the transfer of the business, assets and liabilities of SunWater in relation to the St George channel scheme to an irrigation entity (Mallawa Irrigation) owned by the irrigators of the scheme. The transfer is known as a local management arrangement (local management).

12. The irrigators of the St George channel scheme carry on horticultural businesses and the acquisition of water supplied through the St George channel scheme forms part of the ordinary course of their business.

13. The irrigators of the St George channel scheme are entitled to water allocations in accordance with the provisions of the *Water Act 2000* (Qld).

14. Prior to the transfer to local management, the irrigators' water allocations were supplied pursuant to the St George water supply scheme resource operations licence held by SunWater. After the transfer to local management, the irrigators' water allocations are supplied pursuant to the distribution operations licence held by Mallawa Irrigation (Mallawa Irrigation distribution operations licence).

Mallawa Irrigation

15. On 29 November 2016 Mallawa Irrigation was established as an irrigation entity for the purposes of transition of the St George channel scheme to local management. Mallawa Irrigation is an unlisted public company limited by guarantee. It operates on a not-for-profit basis with all surplus funds required be retained in the business.

16. The constitution of Mallawa Irrigation provides that:

- its assets and income are applied solely in furtherance of its objects and no portion will be distributed directly or indirectly to its Members except as bona fide compensation for services rendered or expenses incurred on behalf of Mallawa Irrigation, and

- on a winding up or distribution, any surplus assets of Mallowa Irrigation may not be paid or distributed to a Member. The surplus assets will be transferred to another body with objectives consistent with Mallowa Irrigation objectives including prohibitions on distributions to Members.

17. The objects of Mallowa Irrigation are to:

- own, operate and maintain the St George channel scheme and to maintain the Thuraggi watercourse
- provide irrigation, water and drainage services to its customers
- purchase, sell, transfer or lease water allocations under a distribution operations licence for the St George channel scheme or to facilitate the purchase, sale, transfer or lease of such water allocations
- plan and provide for the renewal and refurbishment of the St George channel scheme infrastructure, plant and equipment to meet anticipated future requirements, and
- do all such other lawful things as are incidental or conducive to and for the purpose of the attainment of any of these objects.

18. To be eligible for membership in Mallowa Irrigation an irrigator must be located in Australia and hold a water allocation under the Mallowa Irrigation distribution operations licence.

Irrigation offer and transition to local management

19. On 19 January 2018 all eligible irrigators of the St George channel scheme were invited to consider a proposal to transition the St George channel scheme to local management (Irrigation Offer).

20. The Irrigation Offer set out detailed information about the local management proposal including Mallowa Irrigation's proposed structure, governance, operation and management arrangements. The Irrigation Offer asked all eligible irrigators of the St George channel scheme to decide whether they:

- supported the local management proposal to transfer the St George channel scheme from SunWater to Mallowa Irrigation, and
- would apply to become a Member of Mallowa Irrigation.

21. There was no consideration payable by irrigators of the St George channel scheme to apply for, or receive membership in, Mallowa Irrigation.

22. The Irrigation Offer set out that a Member of Mallowa Irrigation would have the opportunity to directly contribute towards the management of the St George channel scheme based on the rights associated with their membership.

23. In order for the transfer to local management to proceed, a minimum percentage of irrigators with water allocations in the St George channel scheme needed to support the transfer to local management. A further minimum percentage of those eligible irrigators needed to apply for membership in Mallowa Irrigation. The requisite percentages of support and applications for membership were achieved.

24. On 30 June 2018, the business, assets and liabilities of the St George channel scheme were transferred from SunWater to Mallowa Irrigation. On 1 July 2018, (Transfer Day), eligible irrigators who applied for membership were entered on the register of members of Mallowa Irrigation.

Membership in Mallowa Irrigation

25. Membership in Mallowa Irrigation:

- is not transferrable by law or otherwise
- carries no entitlement to a distribution of assets or income of Mallowa Irrigation
- carries no entitlement to a distribution on the dissolution or winding up of Mallowa Irrigation
- carries no entitlement to consideration if a Member ceases to hold their membership interest
- carries no application fee
- carries limited liability, and
- is not compulsory for eligible irrigators of the St George channel scheme.

26. A Member will not be entitled to any distribution of assets, income or cash consideration as a result of having, or ceasing to have, a membership interest in Mallowa Irrigation.

27. There are two classes of membership in Mallowa Irrigation:

- Class A Members hold an allocation of water from the St George channel scheme that is equal to or more than a threshold amount and have the right to one vote at a meeting of Members, and
- Class B Members hold less than the threshold amount and do not have a right to vote at a meeting of Members.

28. Class A and Class B membership has the same rights and characteristics provided in paragraph 25. No Member or their associates may together exercise more than 30% of the total votes that may be cast at a meeting of members of Mallowa Irrigation.

Ruling

Income tax

29. The receipt by a Member of a membership interest in Mallowa Irrigation on the Transfer Day will not be assessable as ordinary income under section 6-5 or statutory income under section 6-10.

Capital gains tax

30. Pursuant to subsection 110-25(2), the first element of the cost base of a Member's membership interest in Mallowa Irrigation is nil.

Commissioner of Taxation

22 August 2018

Appendix 1 – Explanation

❶ *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.*

Income tax

31. Subsection 6-1(1) provides that a taxpayer's assessable income consists of ordinary income and statutory income.

Ordinary income

32. Subsection 6-5(1) provides that your assessable income includes income according to ordinary concepts which is called ordinary income.

33. Ordinary income is not defined in the income tax legislation. In order to determine whether the receipt of a membership interest in Mallawa Irrigation by a Member is ordinary income, it is necessary to consider how the courts have determined when a receipt is ordinary income.

34. The High Court's decision in *GP International Pipecoaters Pty Ltd v. FC of Taxation* (1990) 170 CLR 124; 90 ATC 4413 (*GP International*) provides a useful exposition of when non-recurrent receipts may be ordinary income. The High Court stated:

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

35. In the present case, the elements of periodicity, regularity and recurrence are not present in the receipt of the membership interest in Mallawa Irrigation by a Member. There is no right or thing disposed of by the Member in exchange for the receipt of the membership interest. These facts weigh against a conclusion that the receipt is ordinary income.

36. The Court in *GP International* noted that the scope of the transaction, venture or business in respect of which the receipt is received and the recipient's purpose in engaging in that transaction will be relevant in the circumstances of that case. The Court went on to analyse the contract under which the taxpayer had received the receipt as critical in determining the scope of the taxpayer's business and the taxpayer's purpose in engaging in the transaction. After analysing the contract the Court concluded that the establishment payments were received by *GP International* as part of the remuneration it earned in the carrying on of its business.

37. The question in the present case is whether the scope of a Member's business, and their purpose in entering the transaction, was such that the membership interest received was earned in the course of carrying on their business.

38. The irrigators carry on horticultural businesses and receipt of a membership interest in Mallawa Irrigation would not ordinarily be seen as a return within the scope of such a business. In addition, there is no requirement for an irrigator to hold a membership interest in Mallawa Irrigation in order to carry on their business, nor is a membership interest required for an irrigator to be eligible to hold water allocation rights and enter water supply arrangements that are necessary to carry on the activities of their business.

39. The receipt of a membership interest does not have a connection or link to the irrigator's right to their water allocation, water supply or ownership of land, being things that are necessary to carry on the activities of their business.

40. In these circumstances, it is considered that the receipt of a membership interest in Mallawa Irrigation by a Member cannot be directly linked to any ongoing income-earning activity undertaken by a Member.

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

42. Taxation Ruling TR 92/3 *Income tax: whether profits on isolated transactions are income* (TR 92/3) provides guidance on determining whether profits from an isolated transaction are income and therefore assessable as ordinary income under section 6-5. Paragraph 15 of TR 92/3 provides that a profit from an isolated transaction is generally income when both of the following elements are present:

- the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain, and

- the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

43. In accordance with the reasoning in *Myer Emporium*, the intention of a Member would need to be ascertained at the time the membership interest is received on the Transfer Day.

44. By applying for a membership interest to be granted, a Member displays an intention to participate in the ongoing management of the St George channel scheme in accordance with the rights and obligations attached to their class of membership.

45. Members are not entitled to any distribution of assets and income of Mallawa Irrigation nor any distribution on the dissolution or winding up of Mallawa Irrigation. Membership interests in Mallawa Irrigation are not transferrable.

46. As a Member will not be entitled to any distribution of assets, income or cash consideration as a result of having, or ceasing to have, a membership interest in Mallawa Irrigation, there is no evidence of a Member having an intention or motive to make a profit or gain from becoming a member in Mallawa Irrigation.

47. The receipt of the membership interest in Mallawa Irrigation by a Member is considered to be a receipt on capital account. There is not a sufficient nexus between the membership interest and the business activities of the Member to consider the receipt to be on income account.

48. Accordingly, the receipt by a Member of a membership interest in Mallawa Irrigation on the Transfer Day is not considered ordinary income of the Member under section 6-5.

Statutory income

49. Subsections 6-10(1) and (2) state:

- (1) Your **assessable income** also includes some amounts that are *not* *ordinary income.

Note: These are included by provisions about assessable income. For a summary list of these provisions, see section 10-5.

- (2) Amounts that are *not* *ordinary income, but are included in your assessable income by provisions about assessable income, are called **statutory income**.

50. Section 10-5 identifies the following provisions as amounts to be included in assessable income as statutory income:

- bounties and subsidies, section 15-10
- non-cash business benefit, section 21A of the ITAA 1936.

Bounties and subsidies

51. Section 15-10 states:

Your assessable income includes a bounty or subsidy that:

- (a) you receive in relation to carrying on a *business; and
- (b) is not assessable as *ordinary income under section 6-5.

52. A bounty or subsidy will be 'in relation to carrying on a business' where 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 CLR 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 judgement on the facts of each case'. ... What is necessary, at the least, in the present contest is there be a real connection ... the relationship need not be direct, it may also be indirect. ... The expression 'carrying on 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.

53. In the present case, the transfer of the St George channel scheme to local management was implemented as a result of the requisite percentage of eligible irrigators supporting the transfer and a sufficient number seeking to become Members of Mallawa Irrigation. However, there is no requirement for an eligible irrigator to be a Member of Mallawa Irrigation as every eligible irrigator is entitled to a water allocation and water supply independent of whether they are a Member of Mallawa Irrigation or not.

54. There is not a real connection between the receipt of a membership interest in Mallawa Irrigation and the activities of a Member's horticultural business from which assessable income is derived.

55. Accordingly, the receipt of a membership interest in Mallawa Irrigation by a Member is not considered to be a bounty or subsidy assessable under section 15-10.

Non-cash business benefits

56. Subsections 21A(1) and (2) of the ITAA 1936 state:

- (1) For the purposes of this Act, in determining the income derived by a taxpayer, a non-cash business benefit that is not convertible to cash shall be treated as if it were convertible to cash.
- (2) For the purposes of this Act, if a non-cash business benefit (whether or not convertible to cash) is income derived by a taxpayer:

- (a) the benefit shall be brought into account at its arm's length value reduced by the recipient's contribution (if any); and
- (b) if the benefit is not convertible to cash – in determining the arm's length value of the benefit, any conditions that would prevent or restrict the conversion of the benefit to cash shall be disregarded.

57. For section 21A of the ITAA 1936 to apply to the receipt by a Member of a membership interest in Mallowa Irrigation, there must be a 'non-cash business benefit' and 'income derived' by the Member.

58. The phrases 'non-cash business benefit' and 'income derived' are defined in subsection 21A(5) of the ITAA 1936 as follows:

non-cash business benefit means property or services provided after 31 August 1988:

- (a) wholly or partly in respect of a business relationship; or
- (b) wholly or partly for or in relation directly or indirectly to a business relationship.

income derived by a taxpayer means income derived by a taxpayer in carrying on a business for the purpose of gaining or producing assessable income.

59. In the present case, the receipt by a Member of a membership interest in Mallowa Irrigation is not considered ordinary income derived by the Member as explained in paragraphs 32 to 48 above. Therefore, the receipt of a membership interest is not considered a non-cash business benefit received by the Member under section 21A of the ITAA 1936.

Capital gains tax

60. Section 110-25 provides the general rules about the cost base of a CGT asset. Subsection 110-25(1) states that the cost base of a CGT asset consists of five elements. The first element of the cost base of a CGT asset relates to the asset's acquisition cost. Subsection 110-25(2) states:

The first element is the total of:

- (a) the money you paid, or are required to pay, in respect of *acquiring it; and
- (b) the *market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).

Note 1: There are special rules for working out when you are required to pay money or give other property: see section 130-15.

Note 2: This element is replaced with another amount in many situations: see Division 112.

61. Division 112 contains modifications to the general rules about cost base and reduced cost base of a CGT asset. Section 112-20 contains the market value substitution rule. Subsection 112-20(1) states:

The first element of your *cost base and *reduced cost base of a *CGT asset you *acquire from another entity is its *market value (at the time of acquisition) if:

- (a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:
 - (i) *CGT event D1 happening; or
 - (ii) another entity doing something that did not constitute a CGT event happening; or
- (b) some or all of the expenditure you incurred to acquire it cannot be valued; or
- (c) you did not deal at *arm's length with the other entity in connection with the acquisition.

The expenditure can include giving property: see section 103-5.

62. An irrigator within the St George channel scheme did not provide cash or consideration of any other kind in exchange for the receipt of a membership interest in Mallowa Irrigation.

63. As the Member did not incur expenditure to acquire their membership interest in Mallowa Irrigation, paragraph 112-20(1)(a) is satisfied. Consequently, subsection 112-20(1) operates to treat the first element of the cost of a Member's membership interest in Mallowa Irrigation as the market value of the membership interest at the time it is acquired.

64. 'Market value' is defined in Subdivision 960-S.

65. The Commissioner has set out principles that taxpayer's should adopt in determining market value in an ATO Guide titled 'Market valuation for tax purposes'.

66. In the present case Mallowa Irrigation:

- is an unlisted company limited by guarantee
- operates on a 'not for profit' basis and any surplus funds are required to be retained in the business, and
- must transfer any remaining funds to an entity with a like purpose in the event of dissolution or winding up.

67. In the present case Members of Mallowa Irrigation:

- are not entitled to any dividends or distributions of profit or capital
- are not entitled to any distribution on dissolution or winding up of Mallowa Irrigation, and
- cannot trade or transfer their membership interests in Mallowa Irrigation.

68. Accordingly, the first element of the cost base of a Member's membership interest in Mallowa Irrigation at the time it was received on the Transfer Day is nil.

Appendix 2 – Detailed contents list

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

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/3; TR 2006/10

Legislative references:

- ITAA 1936
- ITAA 1936 21A
- ITAA 1936 21A(1)
- ITAA 1936 21A(2)
- ITAA 1936 21A(5)
- ITAA 1997
- ITAA 1997 6-1
- ITAA 1997 6-1(1)
- ITAA 1997 6-5
- ITAA 1997 6-5(1)
- ITAA 1997 6-10
- ITAA 1997 6-10(1)
- ITAA 1997 6-10(2)
- ITAA 1997 10-5
- ITAA 1997 110-25
- ITAA 1997 110-25(1)

- ITAA 1997 110-25(2)
- ITAA 1997 Div 112
- ITAA 1997 112-20
- ITAA 1997 112-20(1)
- ITAA 1997 112-20(1)(a)
- ITAA 1997 Div 230
- ITAA 1997 Subdiv 960-S
- TAA 1953
- Water Act 2000 (Qld)

Case references:

- GP International Pipecoaters Pty Ltd v. FC of Taxation (1990) 170 CLR 124; 90 ATC 4413
- FC of T v. The Myer Emporium (1987) 163 CLR 199
- First Provincial Building Society v. FC of T (1995) 56 CLR 320

Other references:

- [Market Valuation for tax purpose](#)

ATO references

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Income tax ~~ Government payments
Income tax ~~ Assessable income ~~ Other types of income
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