CR 2018/42 - Income tax: Theodore channel scheme - receipt of shares in Theodore Water Pty Ltd

Class Ruling

Income tax: Theodore channel scheme – receipt of shares in Theodore Water Pty Ltd

Contents Para

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 provisions

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 indicated.

Class of entities

3. The class of entities to which this Ruling applies is residents of Australia (within the meaning of subsection 6(1) of the ITAA 1936) and are not 'temporary residents' as defined in subsection 995-1(1), who:

- received shares in Theodore Water Pty Ltd (Theodore Water) on 30 September 2018 (the Transfer Day), and
- are not subject to the Taxation of Financial Arrangements (TOFA) rules in Division 230 of the ITAA 1997 in relation to gains or losses on their shares in Theodore Water.

  (**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 'Shareholder'.

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 27 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 2018 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 Theodore channel scheme is the system used to supply water under water allocations to irrigators who purchase irrigation services in the Dawson Valley 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 Theodore 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 Theodore channel scheme to an irrigation entity (Theodore Water) owned by the irrigators of the scheme. The transfer is known as a 'local management arrangement' (local management).

12. Irrigators within the Theodore channel scheme carry on horticultural businesses and the acquisition of water supplied through the Theodore channel scheme forms part of the ordinary course of their business.

13. The irrigators of the Theodore 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 Theodore 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 Theodore Water (Theodore Water distribution operations licence).

Theodore Water

15. On 3 November 2016 Theodore Water was established as an irrigation entity for the purposes of transition of the Theodore channel scheme to local management. Theodore Water is a private company limited by shares. It operates on a not-for-profit basis with all surplus funds required to be retained in the business.

16. The constitution of Theodore Water provides that:

- its assets and income are applied solely in furtherance of its objects and no portion will be distributed directly or indirectly to the Shareholders except as bona fide compensation for services rendered or expenses incurred on behalf of Theodore Water, and
- on a winding up or distribution, any surplus assets of Theodore Water may not be paid or distributed to a Shareholder. The surplus assets will be transferred to another body with objectives consistent with Theodore Water objectives including prohibitions on distributions to Shareholders.

17. The objects of Theodore Water are to:

- own, operate and maintain the Theodore channel scheme
- provide irrigation, water transportation and drainage services to its customers
- purchase, sell, transfer or lease water allocations under a distribution operations licence for the Theodore 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 Theodore 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 to become a Shareholder in Theodore Water an irrigator must be located in Australia and hold a water allocation under the Theodore Water distribution operations licence (Allocation).

Irrigation offer and transition to local management

19. On 10 April 2018 all eligible irrigators of the Theodore channel scheme were invited to consider a proposal to transition the Theodore channel scheme to local management (Irrigation Offer).

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

- supported the local management proposal to transfer the Theodore channel scheme from SunWater to Theodore Water, and

- would apply to become a Shareholder of Theodore Water.

21. There was no consideration payable by irrigators of the Theodore channel scheme to apply for, or receive shares in, Theodore Water.

22. The Irrigation Offer set out that a Shareholder of Theodore Water would have the opportunity to directly contribute towards the management of the Theodore channel scheme based on the rights associated with their shares.

23. In order for the transfer to local management to proceed, a minimum percentage of irrigators with an Allocation in the Theodore channel scheme needed to support the transfer to local management. A further minimum percentage of those eligible irrigators needed to apply for shares in Theodore Water. The Irrigation Offer closed on 30 May 2018 and the requisite percentages of support and applications for shares were achieved.

24. On 30 September 2018, the transfer of the Theodore channel scheme occurred (Transfer Day).The following occurred on Transfer Day:

- the business, assets and liabilities of the Theodore channel scheme were transferred from SunWater to Theodore Water, and
- eligible irrigators who applied for shares in Theodore Water were issued with shares.

Shares in Theodore Water

25. Shares in Theodore Water:

- carry no entitlement to a distribution of the assets or income of Theodore Water
- carry no entitlement to a distribution on the dissolution or winding up of Theodore Water
- carry no entitlement to consideration if a Shareholder ceases to hold their shares in Theodore Water
- have limited transferability. Other than by surrender, forfeiture or transmission by death, a Shareholder is only permitted to transfer their shares to another eligible irrigator to whom the Shareholder transfers an Allocation
- carry no application fee
- carry limited liability, and
- are not compulsory for eligible irrigators of the Theodore channel scheme that hold an Allocation.

26. A Shareholder will not be entitled to any distribution of assets, income or cash consideration as a result of holding, or ceasing to hold, shares in Theodore Water.

27. A Shareholder is permitted to hold one ordinary share for each megalitre of their total Allocation. No Shareholder or their associates may together hold more than 35% of the Shares in Theodore Water at any time.

Ruling

Income tax

28. The receipt of shares in Theodore Water by a Shareholder 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

29. Pursuant to subsection 110-25(2), the first element of the cost base of the shares in Theodore Water received by a Shareholder is nil.

Commissioner of Taxation
31 October 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

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

Ordinary income

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

32. Ordinary income is not defined in the income tax legislation. In order to determine whether the receipt of shares in Theodore Water by a Shareholder is ordinary income, it is necessary to consider how the courts have determined when a receipt is ordinary income.

33. 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.' ((1990) 170 CLR 124 at 138; 90 ATC 4413 at 4420)

34. In the present case, the elements of periodicity, regularity and recurrence are not present in the receipt of shares in Theodore Water by a Shareholder. There is no right or thing disposed of by the Shareholder in exchange for the receipt of their shares. These facts weigh against a conclusion that the receipt is ordinary income.

35. 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.

36. The question in the present case is whether the scope of a Shareholder's business, and their purpose in entering the transaction, is such that the receipt of shares in Theodore Water is earned in the course of carrying on their business.

37. The irrigators carry on horticultural businesses and receipt of shares in Theodore Water 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 shares in Theodore Water in order to carry on their business, nor are shares in Theodore Water 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.

38. The receipt of shares in Theodore Water does not have a connection or link to the irrigator's right to their Allocation, water supply or ownership of land, being things that are necessary to carry on the activities of their business.

39. In these circumstances, it is considered that the receipt of shares in Theodore Water by a Shareholder cannot be directly linked to any ongoing income-earning activity undertaken by a Shareholder.

40. The case of *FC of T v. The Myer Emporium* (1987) 163 CLR 199 (*Myer Emporium*) dealt with gains from a transaction that was isolated and extraordinary in terms of the normal business operations of the taxpayer. In *Myer Emporium*, the High Court held that the amount 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.

41. Taxation Ruling TR 92/3 *Income tax: whether profits on isolated transactions are income* 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.

42. In accordance with the reasoning in *Myer Emporium*, the intention of a Shareholder would need to be ascertained at the time their shares are received on the Transfer Day.

43. By applying for shares in Theodore Water, a Shareholder displays an intention to participate in the ongoing management of the Theodore channel scheme in accordance with the rights and obligations attached to their shares.

44. Shareholders are not entitled to any distribution of assets and income of Theodore Water or any distribution on the dissolution or winding up of Theodore Water. Shares in Theodore Water have limited transferability.

45. As a Shareholder will not be entitled to any distribution of assets, income or cash consideration as a result of holding, or ceasing to hold, shares in Theodore Water, there is no evidence that a Shareholder had an intention or motive to make a profit or gain from becoming a Shareholder in Theodore Water.

46. The receipt of shares in Theodore Water by a Shareholder is considered to be a receipt on capital account. There is not a sufficient nexus between the shares and the business activities of the Shareholder to consider the receipt to be on income account.

47. Accordingly, the receipt of shares in Theodore Water by a Shareholder on the Transfer Day is not considered ordinary income of the Shareholder under section 6-5.

Statutory income

48. 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***.

49. Section 10-5 includes in assessable income:

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

Bounties and subsidies

50. 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.

51. 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 context 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.

52. In the present case, the transfer of the Theodore 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 Shareholders of Theodore Water. However, there is no requirement for an eligible irrigator to be a Shareholder in order carry on the activities of their business. Every eligible irrigator is entitled to their Allocation and water supply regardless of whether or not they are a Shareholder of Theodore Water.

53. There is not a real connection between the receipt of shares in Theodore Water and the activities of a Shareholder's horticultural business from which assessable income is derived.

54. Accordingly, the receipt of shares in Theodore Water by a Shareholder is not considered to be a bounty or subsidy assessable under section 15-10.

Non-cash business benefits

55. 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.

56. For section 21A of the ITAA 1936 to apply to the receipt of shares in Theodore Water, there must be a 'non-cash business benefit' and 'income derived' by the Shareholder.

57. The phrases 'non-cash business benefit' and 'income derived by a taxpayer' 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.

58. In the present case, the receipt of shares in Theodore Water by a Shareholder is not considered ordinary income derived by the Shareholder as explained in paragraphs 31 to 47 of this Ruling. Therefore, the receipt of shares is not considered a non-cash business benefit received by the Shareholder under section 21A of the ITAA 1936.

Capital gains tax

59. 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.

60. Division 112 contains modifications to the general rules about the cost base and reduced cost base of a CGT asset. Section 112-20 contains the market value substitution rule. Paragraph 112-20(1)(a) of the ITAA 1997 provides that, if you did not incur any expenditure to acquire a CGT asset from another entity, the first element of the cost base and reduced cost base of the asset is its market value.

61. However, Subsection 112-20(3) provides situations in which the market value substitution rule in subsection 112-20(1) does not apply.

62. Item 5 of the table in subsection 112-20(3) applies to disregard the market value substitution rule where a share in a company or a right to acquire a share or debenture in a company, is issued or allotted to the acquirer and the acquirer did not pay or give anything for it.

63. The Shareholders did not provide consideration of any kind in exchange for the receipt of their shares in Theodore Water. Therefore, item 5 of the table in subsection 112-20(3) applies to disregard the market value substitution rule in section 112-20.

64. Accordingly, the first element of the cost base of a share in Theodore Water at the time it is received by a Shareholder on the Transfer Day is nil.

Appendix 2 – Detailed contents list

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

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TR 92/3

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1936 21A
- ITAA 1936 21A(1)
- ITAA 1936 21A(2)
- ITAA 1936 21A(5)
- ITAA 1936 996-191
- 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 15-10
- 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 112-20(3)
- ITAA 1997 130-15
- ITAA 1997 Div 230
- ITAA 1997 995-1(1)
- TAA 1953
- Water Act 2000 (Qld)

Case references:

- GP International Pipecoaters Pty Ltd v. Federal Commissioner of Taxation (1990) 21 ATR 1; 90 ATC 4413
- Federal Commissioner of Taxation v. The Myer Emporium Ltd (1987) 18 ATR 693; 87 ATC 4363
- First Provincial Building Society v. Commissioner of Taxation (1995) 30 ATR 207; 95 ATC 4145

ATO references

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