Victoria Power Networks Pty Ltd v Commissioner of Taxation -

Decision impact statement

Victoria Power Networks Pty Ltd v Commissioner of Taxation

Court citation(s):	[2020] FCAFC 169
Venue:	Full Federal Court
Venue reference no:	VID237-240 of 2019
Judge name(s):	Logan, Colvin and Thawley JJ
Judgment date:	21 October 2020
Appeals on foot:	No
Decision outcome:	Partly favourable to the Commissioner

Impacted advice

This decision has no impact on any related advice or guidance.

Précis

This Decision impact statement outlines the ATO's response to the Full Federal Court's decision which concerns:

- whether customer cash contributions received by electricity distributors for connection to the network were ordinary income under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997), and
- the amount to be brought to account as a non-cash business benefit under section 21A of the *Income Tax Assessment Act 1936* (ITAA 1936) in respect of the receipt of assets provided by customers upon connection to the network.

Brief summary of facts

Powercor Australia Pty Ltd and CitiPower Pty Ltd (the distributors) provide electricity distribution services in Victoria pursuant to licences issued under the *Electricity Industry Act 2000* (Vic). The distributors are each subsidiary members of a consolidated tax group of which Victoria Power Networks Pty Ltd (the taxpayer) is the head company.

Under the terms of their licences, the distributors were required to connect new customers to their respective electricity networks when requested. For safety reasons, certain connection works were required to be carried out by the relevant distributor, while 'contestable works' could be carried out by either the distributor or the customer, at the customer's option. Depending on the type of works involved and the choice made by the customer, either the distributor undertook construction of the relevant connection assets (Option 1), or the customer undertook construction of the assets (Option 2). Under Option 2, the customer was required to transfer the assets to the distributor at the time of the connection (transferred assets).

Electricity Industry Guideline No. 14: Provision of services by electricity distributors (Guideline 14) provided that a customer was not required to contribute to the cost of the connection unless the 'incremental cost' exceeded the 'incremental revenue'.

Under Guideline 14, the incremental cost is an estimate of the capital cost of the connection works (including construction of the connection assets) plus the present value of the distributors' future maintenance and operating costs in providing the connection services to the customer. The incremental revenue is an estimate of the present value of the future revenue expected to be earned from the connection.

For so-called 'uneconomic connections', where the incremental cost exceeded the incremental revenue, the distributor was permitted under Guideline 14 to seek a contribution from the customer capped at the amount of the difference (the shortfall). Under Option 1, the customer made a contribution in cash to the distributor equal to the shortfall (customer cash contribution). Under Option 2, where the estimated cost of construction of the transferred assets exceeded the amount of the shortfall, the distributor paid a rebate to the customer equivalent to the excess.

The price the distributors could charge for electricity distribution services was set by an independent regulator and was based on the distributors' 'regulatory asset base' (RAB). Under Option 1, the RAB was increased by the distributors' expenditure on the new connection assets less the customer cash contribution. Under Option 2, the RAB was increased by the amount of the rebate paid by the distributor.

At first instance in the Federal Court in *Victoria Power Networks Pty Ltd v Commissioner of Taxation* [2019] FCA 77 before Moshinsky J, the taxpayer argued that customer cash contributions under Option 1 were not assessable as ordinary income under section 6-5 of the ITAA 1997, but rather they were an assessable recoupment pursuant to section 20-20 of the ITAA 1997. In relation to Option 2, the taxpayer argued that the arm's length value of the transferred assets for the purposes of section 21A of the ITAA 1936 was equal to the rebate. In that case, the amount brought to account as income under paragraph 21A(2)(a) of the ITAA 1936, being the arm's length value reduced by the recipient's contribution (that is, the rebate), was nil.

Moshinsky J rejected both of the taxpayer's arguments holding, consistent with the Commissioner's arguments, that customer cash contributions were ordinary income under section 6-5 of the ITAA 1997 and that the arm's length value of the transferred assets was equal to the estimated cost of construction. In that case, the amount brought to account under paragraph 21A(2)(a) of the ITAA 1936 was the shortfall (that is, the estimated cost of construction less the rebate).

The taxpayer appealed to the Full Federal Court, which dismissed the taxpayer's appeal in respect of customer cash contributions, but allowed the appeal in respect of the arm's length value of the transferred assets.

The Commissioner had also argued in relation to Option 2 that payment of the customer contribution permitted under Guideline 14 occurred by way of set-off against the value of the transferred assets, and was therefore income under ordinary concepts without recourse to section 21A of the ITAA 1936. However, that argument was rejected by Moshinsky J and by the Full Federal Court.

Neither party sought special leave to appeal to the High Court.

Issues decided by the Court

Notwithstanding that Logan J agreed with the reasons of Colvin J (and Thawley J with respect to the section 21A of the ITAA 1936 issue) and Thawley J agreed with the reasons of both Logan J and Colvin J, their Honours each gave separate reasons for judgment.

Customer cash contributions

In contending that customer cash contributions were not received as ordinary income, the taxpayer relied on the proposition from *GP International Pipecoaters Pty Ltd v Federal Commissioner of Taxation (Cth)* [1990] HCA 25 (*GP International Pipecoaters*) that:

> … when the amount is received by way of gift or subsidy to replenish or augment the payee's capital … the receipt cannot fairly be said to be a product or incident of the payee's income-producing activity …

The taxpayer argued that customer cash contributions subsidised the capital cost of the connection works and were not paid as remuneration for the provision of connection services. In particular, Guideline 14 required customers to make customer cash contributions 'as a contribution to the capital cost of new works for connection'. Further, the taxpayer argued that regulatory regime for setting the prices that could be charged for distribution services did not permit the distributors to earn a profit on such connections.

In rejecting the taxpayer's arguments, their Honours referred to the limitations placed on the proposition from *GP International Pipecoaters* relied on by the taxpayer (at [74]):

> … But it cannot be accepted that an intention on the part of a payer and a payee or either of them that a receipt be applied to recoup capital expenditure by the payee determines the character of a receipt when the circumstances show that the payment is received in consideration of the performance of a contract, the performance of which is the business of the recipient or which is performed in the ordinary course of the business of the recipient.

Instead, their Honours considered that:

- The business of each distributor involved the supply of electricity distribution services to customers connected to the distribution network (at [15] and [80]).
- The connection of customers to the electricity distribution network was a part of that business (at [21], [69] and [114]).
- Customer cash contributions were part of the price paid to distributors for those services and were therefore received by each of the distributors in the ordinary course of their business and were ordinary income for the purposes of subsection 6-5(1) of the ITAA 1997 (at [18], [21], [82], [83] and [114]).

Their Honours also rejected (at [21], [81] and [114]) the taxpayer's contentions that customer cash contributions were a reimbursement or recoupment of capital costs. Rather, as Colvin J pointed out (at [81]):

> … The regulation required a determination as to whether incremental revenue was exceeded by incremental cost. The required calculation involved an assessment of the net present value of revenue that might be earned over 15 or 30 years. As to costs, it was not confined to the connection costs. It included operating and maintenance costs. The shortfall was not a reimbursement for identified capital costs. It was to cover the deficiency in revenue in supplying distribution services to the customer at the prevailing capped price for distribution services.

Further, Colvin J (at [81]) held that the requirement that the shortfall be covered by a customer cash contribution ensured that the price paid for the 'connection and distribution services was profitable'.

Transferred assets

Colvin J at [93] and Thawley J at [116] (with whom Logan J both agreed) rejected the Commissioner's contention that Option 2 resulted in the distributors receiving the amount of the customer contribution as ordinary income on the basis that there was no obligation on customers to make any payment to the distributors under Option 2. Rather, the obligation on the customer was to undertake the contestable works and to transfer the assets to the relevant distributor, and the obligation on the distributors was to pay the rebate to the customer and provide the connection.

As a result, the issue to be determined was the amount to be brought to account as income pursuant to paragraph 21A(2)(a) of the ITAA 1936 in relation to the non-cash business benefits received by the distributors from customers, being the arm's length value of the transferred assets reduced by the recipient's contribution (if any).

Arm's length value is relevantly defined in subsection 21A(5) of the ITAA 1936 as follows:

> **arm's length value**, in relation to a non-cash business benefit, means:
>
> (a) the amount that the recipient could reasonably be expected to have been required to pay to obtain the benefit from the provider under a transaction where the parties to the transaction are dealing with each other at arm' s length in relation to the transaction …

It was common ground that the transferred assets were received by the distributors on revenue account, the distributors and customers were dealing with each other at arm's length, and the amount of the recipient's contribution was equal to the rebate.

Their Honours ultimately concluded that the arm's length value of the transferred assets was an amount equal to the rebate. In coming to this conclusion, their Honours focused on the regulated market in which the actual parties transacted and the effect that the regulations had on arm's length dealings in those circumstances. In particular, their Honours observed that where the distributors were required to provide an 'uneconomic connection' the customer could be required to bear the shortfall. Therefore the distributors could only reasonably be expected to pay the rebate for the transferred assets, rather than the full amount of the estimated costs of the contestable work undertaken by the customer (at [26], [30], [36], [41], [96], [98–99], [103–104], and [123]).

Colvin J considered that the test requires regard to be had to the manner in which the events have occurred (at [94]) or the form of transaction (at [104]). His Honour observed at [105] that for an Option 2 'uneconomic connection', Guideline 14 did not impose an obligation on the customer to pay the shortfall to the distributor. Rather, it required the distributor to connect the customer to the electricity distribution network, but only if the customer bore the burden of the shortfall. Hence, his Honour held at [105] that the amount the distributor could reasonably have been expected to pay for the benefit of the transferred assets was the estimated cost of construction less the shortfall.

Although agreeing with the reasons of Colvin J (at [3]), Logan J provided additional reasons. His Honour held at [26–27] that the test is objective and concerns not the transaction, but *a* transaction where the parties are dealing at arm's length. Further, at certain paragraphs (see [29], [32] and [41]), Logan J described the relevant test by reference to an electricity distributor and a new customer (rather than the actual parties). According to his Honour at [40], where the incremental cost is greater than the incremental revenue, it was not reasonable to expect the distributor to pay the estimated cost of construction of the transferred assets to obtain the benefit of the assets. Moreover, his Honour observed at [41] that the customer has agreed to bear part of the cost of the construction of the connection assets. The rebate also represented the extent to which the expected revenues from the connection would cover the expected costs. Hence, objectively the rebate is the amount that the distributor could reasonably be expected to pay to obtain the benefit of the transferred assets and was in fact the amount it paid.

Thawley J agreed with the reasons of both Logan J and Colvin J (at [109]). In separate reasons for judgment his Honour concluded at [119] that the evident object of the test was to determine the value of the benefit objectively on the basis of an arm's length dealing. However, his Honour went further to add at [122] that it would only be necessary to hypothesise 'a transaction' different from 'the transaction' if the parties were not dealing with each other at arm's length. Here, the distributor and customer dealt with each other at arm's length and in the regulated market in which the distributor and the customer were required to transact, what the distributor could reasonably be expected to pay to acquire the benefit of the transferred assets was the amount of the rebate. According to his Honour at [123]:

> … [The distributor] could not reasonably have been expected to have been required to pay for the benefit of the transferred assets an amount representing the whole of the construction costs in "a transaction" or arm's length dealing in circumstances where: (a) the construction costs were paid by the customer, who was required ultimately to bear the "shortfall"; and (b) [the distributor] was only required to pay to the customer an amount representing a portion of the construction costs.

ATO view of decision

Customer cash contributions

The decision of the Full Federal Court is consistent with the Commissioner's view that customer cash contributions were ordinary income for the purposes of section 6-5 of the ITAA 1997.

The Commissioner considers that the decision reflects the correct application of the established principle that 'a profit or gain made in the ordinary course of carrying on a business constitutes income' (*Commissioner of Taxation v Myer Emporium Ltd* [1987] HCA 18).

In particular, the Commissioner notes the flaw in the taxpayer's contention identified by Logan J at [19]:

> … It is difficult to see why the profit or gain arising from a distributor's business as a supplier of an electricity distribution service to a customer should not include an amount received by it under a supply agreement with a customer merely because one undissected component of that amount was calculated to compensate in part the distributor for its expenditure on the new plant and equipment required for the supply of the electricity distribution service.

Transferred assets

In this case, the Full Federal Court found that the regulatory regime in which the distributors and customers transacted, had the effect that the distributors could not reasonably be expected to pay the estimated cost of construction of the transferred assets because the regulations required the customer to bear part of that cost to the extent of the shortfall. Importantly, the Full Federal Court found that Guideline 14 did not impose any obligation on the customer to pay that shortfall to the distributor as part of the price for the connection. As a result, the arm's length value of the transferred assets was the estimated cost of construction *less* the shortfall. Given that this was equal to the rebate that was paid, there was no amount to be brought to account as income pursuant to paragraph 21A(2)(a) of the ITAA 1936.

Comparison of tax outcomes

The effect of the Court's decision is that although 'from the perspective of the distributor there is no economic difference between Option 1 and Option 2' (at [54]) *before* tax, there is one *after* tax. This is because under Option 1 the shortfall amount is derived as income at the time of the transaction and the entire costs of construction are deducted by way of capital allowances over time. Whereas under Option 2, no amount is brought to account as assessable income and capital allowances are limited to the cost of construction *less* the shortfall. The net effect on taxable income is the same but there is a significant timing difference. This result may not be intended and is currently being examined.

Implications

The decision of the Full Federal Court in relation to section 21A has implications for other electricity distributors subject to equivalent regulatory regimes and may have implications for participants in industries with closely similar regulatory regimes. The Commissioner is currently assessing the potential impact of the decision on other infrastructure providers and regulated industries such as gas, water, telecommunications, rail and ports. However, the Commissioner does not consider this aspect of the decision to have wider application beyond similarly regulated industries. This is because the outcome of the decision was significantly influenced by the regulated environment in which the actual parties transacted which, in effect, prescribed the amount that would be paid for the non-cash business benefit in an arm's length dealing.

In normal cases where the market is not affected in this way, the operation of section 21A of the ITAA 1936 may be expected to have, in broad terms, the result that a non-cash business benefit will be brought to tax at the prevailing market cash price required to obtain it from any available supplier. That is because in normal market conditions an arm's length price between the parties will not significantly differ from the price that applies between other arm's length parties. Also, the arm's length value of a non-cash business benefit will not usually be less than the cost of supplying it. This is because suppliers do not normally charge less than their costs in arm's length conditions. That was not the outcome in the circumstances of this case because of the regulated environment. Otherwise, the value to the distributor of obtaining the transferred assets and the arm's length amount that it might be expected to pay for them would be the same as the construction cost. This decision is therefore one on special facts.

As noted above, a consequence of the decision that the arm's length value of the transferred assets for the purposes of section 21A of the ITAA 1936 is the rebate and not the estimated cost of construction is that capital allowance deductions available under Division 40 of the ITAA 1997 are also relevantly limited to the amount of the rebate.

Implications for impacted advice or guidance

None.

Legislative references

Income Tax Assessment Act 1936
21A
21A(2)(a)
21A(5)

Income Tax Assessment Act 1997
6-5

6-5(1)
20-20
Div 40

Electricity Industry Act 2000 (Vic)

Case references

Commissioner of Taxation v Myer Emporium Ltd [1987] HCA 18; 163 CLR 199; 87 ATC 4363; 18 ATR 693
GP International Pipecoaters Pty Ltd v Federal Commissioner of Taxation (Cth) [1990] HCA 25; 170 CLR 124; 90 ATC 4413; 21 ATR 1; ALJR 382
Victoria Power Networks Pty Ltd v Commissioner of Taxation [2019] FCA 77; 2019 ATC 20-682; 109 ATR 537

Other references

Electricity Industry Guideline No. 14: Provision of services by electricity distributors

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