

TREASURY DISCUSSION PAPER

WATER TRANSFORMATION AND CAPITAL GAINS TAX

NOTE TO PARTICIPANTS

This paper is a guide as to how the broad principles announced by the Government might operate.

1 Introduction

On 27 February 2009, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, announced that the Government will provide a capital gains tax (CGT) roll-over for water transformation arrangements. This roll-over will apply to CGT events that happen on and after 1 July 2008. A copy of the press release is available on the [Assistant Treasurer's website](#).

The *Water Act 2007* requires the Australian Competition and Consumer Commission to advise the Minister for Climate Change and Water on water market rules for the Murray Darling Basin. The purpose of the water market rules is to free up the trade of water access entitlements within the Basin by ensuring that the policies or administrative requirements of irrigation infrastructure operators do not represent a barrier to trade.

These rules are expected to come into force in March 2009.

The water market rules will include rules relating to irrigation infrastructure operators' policies that prevent or unreasonably delay transformation arrangements. Transformation is a voluntary process by which an irrigator permanently transforms their entitlement to water under an irrigation right against an irrigation infrastructure operator into a water access entitlement that is held by someone other than the operator, including an individual water entitlement held by the irrigator. Transformation also has the effect of reducing the operator's water entitlement or licence.

The proposed CGT roll-over will be available when an irrigator transforms their entitlement to water under an irrigation right against an operator into an individual statutory entitlement held by the irrigator.

The Government will also provide that all taxpayers (that is, not just those in the irrigation industry) will be able to recognise fees such as termination fees when calculating a capital gain or capital loss on an asset. Subject to transitional arrangements that are outlined below, this change will also apply to CGT events that happen on and after 1 July 2008

2 Purpose

This discussion paper forms the basis for consultation on the design of this proposal and sets out, in broad terms, the way it may be implemented. The purpose of this discussion paper is to provide interested parties with an opportunity to comment on the proposal's design.

3 Background

3.1 Operation of existing law

Ordinarily, the ending of an irrigator's interest in an irrigation infrastructure operator would typically trigger a CGT taxing point and the realisation of a capital gain or loss as appropriate. The specific CGT event would depend on how the irrigator's interest in the operator was held and how the transformation took place.

The ending or partial ending of an operator's water access entitlement would also typically trigger a CGT taxing point. The specific CGT event would depend on the governance arrangements or process of transformation.

The existing statutory licence CGT roll-over available in Subdivision 124-C of the *Income Tax Assessment Act 1997* (ITAA 1997) is unlikely to be available for irrigators who choose to transform and may be unavailable for operators. This is because the statutory licence roll-over requires that the taxpayer own one or more statutory licences which end and that the statutory licences are replaced by one or more new statutory licences that authorise substantially similar activity. In the case of transformation arrangements:

- the irrigator receives a new statutory licence for water, but their initial entitlement to water under an irrigation right held against the operator is not a statutory licence; and
- the operator does not necessarily receive a replacement statutory licence.

Where a 'group' water licence is held in a partnership and one of the partners chooses to transform, there would typically be CGT consequences for each partner. Each partner is taken to own part of the transformed interest proportionate to their ownership share of the partnership. The irrigator choosing to transform may also give up their interest in the rest of the partnership's assets.

3.2 Termination fees and exit fees

Following transformation, an irrigator may choose to dispose of their individually held statutory licence. In this case the irrigator has the choice between retaining access to the operator's irrigation network and continuing to pay an annual access fee, or terminating access and paying a termination fee.

The existing cost base rules for the CGT regime are contained in Subdivision 110-A of the ITAA 1997. There are five elements to an asset's cost base. Incidental costs are included in the second element of an asset's cost base.

However, the existing incidental costs do not include termination fees or exit fees.

As a result, an irrigator who chooses to terminate access to an operator's network and incurs a termination fee would be unable to include this fee when calculating a capital gain or

capital loss on the relevant asset under the current law. Typically this will be the asset from which the irrigator's water delivery right is derived.

4 Policy design of proposal

There are two main aspects to the policy design for this proposal. The first is to provide a CGT roll-over for transformation arrangements and the second is to allow, more generally, taxpayers to include termination and exit fees incurred in relation to an asset in the asset's cost base.

Each aspect is discussed in further detail below.

4.1 CGT roll-over for transformation arrangements

4.1.1 Disregard capital gains or capital losses arising from the transformation of an irrigator's water entitlement under an irrigation right into a statutory licence

Capital gains or capital losses arising from an irrigator exchanging assets that represent an entitlement to water under an irrigation right against another entity for a statutory licence (water access entitlement) would be disregarded.

This irrigation right is a right that the irrigator has against the operator to receive water. The right is not a water access right or a water delivery right as such. Rather an irrigator's irrigation right may be an explicit or implicit contract with the operator arising from the irrigator holding a membership interest in the operator, such as shares or trust interests. These membership interests may have rights in addition to the irrigation rights attached to them.

Capital gains or capital losses arising from the disposal of these assets more generally (even where they represent other rights) would also be disregarded, but only when the irrigator acquires replacement assets for these other rights under the exchange.

Capital gains or capital losses arising to the operator from this exchange would also be disregarded.

Example 1

Waterworks Ltd is an operator with a 300GL statutory licence. It has three shareholders: Leo, Lily and Mark. Each holds 100 Class A shares in Waterworks.

Each share entitles the holder to 1GL of water and its delivery and one vote at the company's Annual General Meeting (AGM). The entitlement to 1GL of water is an explicit irrigation right.

Assume Leo chooses to transform his entitlement to water under an irrigation right against Waterworks. This involves Leo exchanging his shares for 100 Class B shares and a 100GL statutory licence. Each of these Class B shares entitles Leo to the delivery of 1 GL of water and one vote at the company's AGM.

Any capital gains (or capital losses) arising from Leo transforming his entitlement to water under an irrigation right into a 100GL statutory licence would be disregarded under this roll-over. These taxing points would typically arise under the following transactions:

- Leo's Class A shares are cancelled triggering CGT event C2.
- Waterworks' 300GL statutory licence is reduced to 200GL. Depending on how this transaction is structured and the nature of the entitlement, this reduction would be likely to trigger CGT event A1 for Waterworks.
 - For example, Waterworks could subdivide its 300GL statutory licence into two statutory licences – a 200GL entitlement and 100GL entitlement – thereby triggering CGT event C2 and a possible roll-over under Subdivision 124-C of the ITAA 1997. Waterworks could then dispose of the 100GL entitlement to Leo, thereby triggering CGT event A1.
 - Alternatively, Leo could apply for a new statutory licence with a zero entitlement and Waterworks could assign 100GL of its 300GL statutory licence to Leo's statutory licence. This assignment of 100GL would trigger CGT event A1 in relation to part of Waterworks' statutory licence.

4.1.2 Transformation consequences for irrigators with pre-CGT irrigation rights

Pre-CGT assets are assets that are acquired (or deemed to have been acquired) by the taxpayer prior to 20 September 1985. The CGT provisions typically disregard capital gains or capital losses arising on these assets.

If an irrigator's entitlement to water under an irrigation right against an operator is derived from pre-CGT assets, then their replacement statutory licence would be taken to be a pre-CGT asset.

Any other assets received by the irrigator under the exchange would also be taken to be pre-CGT assets.

Example 2

Further to Example 1, but assume Leo acquired all of his Class A shares in Waterworks in 1984.

Leo's 100GL statutory licence would be taken to be a pre-CGT asset. The 100 Class B shares Leo acquires in Waterworks under the exchange would also be taken to be pre-CGT assets.

4.1.3 Irrigator with post-CGT irrigation rights

Post-CGT assets are assets that are acquired by the taxpayer after 19 September 1985.

If an irrigator's entitlement to water under an irrigation right against an operator is derived from post-CGT assets, then their replacement statutory licence would be taken to be a post-CGT asset. Any other assets received by the irrigator under the exchange would also be taken to be post-CGT assets.

Example 3

Further to Example 1, Lily also chooses to transform her entitlement to water under an irrigation right to a statutory licence following Leo's transformation.

Lily acquired her Class A shares in Waterworks in 2000 (post-CGT).

Waterworks cancels Lily's Class A shares and issues her with 100 Class B shares. Any capital gains or capital losses arising to Lily from this cancellation would be disregarded. Lily also acquires a statutory licence with a water allocation of 100GL from Waterworks.

Lily's statutory licence and her 100 Class B shares are all post-CGT assets.

Section 4.1.3.1 — Cost base modifications to statutory licence and other replacement assets

The first element of the cost base (or reduced cost base) of the irrigator's statutory licence (that is acquired under the exchange) would be equal to the cost base of the irrigator's original assets from which the entitlement to water under an irrigation right is derived.

Irrigation right derived from assets which carry additional rights and entitlements

In some situations, the assets from which an irrigator's entitlement to water under an irrigation right is derived may carry additional rights and entitlements. In these situations, the cost base of the assets from which the entitlement to water under an irrigation right is derived (in the hands of the irrigator just before the exchange) would be apportioned between the statutory licence and the other replacement assets or any remaining assets, reflecting their relative values. These apportioned amounts would then form the first element of the cost base (or reduced cost base) of these assets following the exchange.

Example 4

Further to Example 3, Lily's 100 Class A shares in Waterworks have a cost base of \$100,000 each. The total cost base of these shares is \$10,000,000.

Following transformation, Lily's 100GL statutory licence has a market value of \$100,000,000. The 100 Class B shares have a combined market value of \$1,000,000.

Based on these values, Lily's statutory licence represents 99 per cent of the total proceeds of the transformation arrangement.

- This is calculated as follows:
 - The value of the total proceeds received is \$101,000,000; that is \$100,000,000 plus \$1,000,000.
 - The value of the statutory licence relative to the total proceeds received is determined by dividing the value of the statutory licence by the total value of the proceeds; that is \$100,000,000 divided by \$101,000,000.

The first element of the cost base of Lily's statutory licence is \$9,900,000.

- This is calculated as follows:
 - 99 per cent of the \$10,000,000 total cost base of the 100 Class A shares is \$9,900,000.

The Class B shares that Lily receives represent the other 1 per cent of the total proceeds. Consequently the cost base of these shares is \$100,000.

- This is calculated as follows:
 - 1 per cent of the \$10,000,000 total cost base of the 100 Class A shares is \$100,000.

The first element of the cost base of each of Lily's 100 Class B shares is \$1,000.

- This is calculated as follows:
 - \$100,000 total cost base value of the 100 Class B shares divided by 100 shares.

4.1.4 Irrigator with pre-CGT and post-CGT irrigation rights

If an irrigator's entitlement to water under an irrigation right is derived from both pre-CGT and post-CGT assets (but in relation to the one operator), then their replacement statutory licence would be taken to consist of two assets, one of which is pre-CGT and the other post-CGT.

- These assets would reflect the proportions of the pre-CGT and post-CGT assets from which the irrigation right was derived.
- In determining the proportions, regard would need to be given to the number, market value and character of the original assets at the time of the exchange.

Any other assets received by the irrigator under the exchange would also be taken to consist of both pre-CGT and post-CGT assets.

- As above, the proportion of these assets would reflect the proportions of the pre-CGT and post-CGT assets from which these non irrigation rights were derived.

The CGT provisions typically disregard capital gains or capital losses arising on pre-CGT assets.

Example 5

Further to Example 1, assume that Mark also chooses to transform his entitlement to water under an irrigation right in Waterworks into a statutory licence. Under the transformation arrangement, Mark exchanges his 100 Class A shares for 100 Class B shares and a 100GL statutory licence. Any capital gains or capital losses arising to Mark from this exchange would be disregarded.

Mark acquired 25 of his Class A shares in 1984 and the remaining 75 in 1987.

Mark is taken to have acquired two statutory licences – one pre-CGT and the other post-CGT.

Reflecting the number of pre-CGT Class A shares he owned, Mark is taken to have acquired a 25GL pre-CGT statutory licence and a 75GL post-CGT statutory licence.

Section 4.1.4.1 — Cost base modifications to statutory licence and other replacement assets

The first element of the cost base (or reduced cost base) of the irrigator's post-CGT statutory licence (that is acquired under the exchange) would be equal to the cost base of the irrigator's original post-CGT assets from which their entitlement to water under an irrigation right is derived.

Irrigation right derived from assets which carry additional rights and entitlements

As noted in section 4.1.3.1, the assets from which an irrigator's entitlement to water under an irrigation right is derived may carry additional rights and entitlements. In these situations, the cost base of the post-CGT assets from which the irrigation right was derived (in the hands of the irrigator just before the exchange) would be apportioned between the post-CGT statutory licence and the other post-CGT replacement assets or remaining assets, reflecting their relative values. These apportioned amounts would then form the first element of the cost base (or reduced cost base) of these assets following the exchange.

Example 6

Further to Example 5, Mark's 75 post-CGT Class A shares in Waterworks have a cost base of \$20,000 each. The total cost base of these shares is \$1,500,000.

Following transformation, Mark's 75GL post-CGT statutory licence has a market value of \$75,000,000. The 75 post-CGT Class B shares have a combined market value of \$750,000.

Based on these values, Mark's statutory licence represents 99 per cent of the total proceeds of the transformation arrangement for his post-CGT Class A shares.

- This is calculated as follows:
 - The value of the total proceeds received is \$75,750,000; that is \$75,000,000 plus \$750,000.
 - The value of Mark's statutory licence relative to the total proceeds he receives is determined by dividing the value of the statutory licence by the total value of the proceeds; that is \$75,000,000 divided by \$75,750,000.

The first element of the cost base of Mark's 75GL statutory licence is \$1,485,000.

- This is calculated as follows:
 - 99 per cent of the \$1,500,000 total cost base of the 100 Class A shares is \$1,485,000.

The Class B shares that Mark receives represent the other 1 per cent of the total proceeds for his post-CGT Class A shares. Consequently the cost base of these shares is \$15,000.

- This is calculated as follows:
 - 1 per cent of the \$1,500,000 total cost base of the 100 Class A shares is \$15,000.

The first element of the cost base of each of Mark's 75 Class B shares is \$200.

- This is calculated as follows:
 - \$15,000 total cost base value of the 75 Class B shares divided by the 75 shares.

4.2 Provision for termination and exit fees in an asset's cost base

Costs imposed by an entity on a taxpayer, as a result of an asset of the taxpayer ending its connection with the entity, would be included in the asset's cost base as an incidental cost.

- For example, the relevant asset in the irrigation industry may be the water delivery right. However, this would depend on the facts of a particular arrangement.

To ensure that taxpayers do not receive a double benefit, any capital proceeds received by the taxpayer from a CGT event happening to their asset will not be reduced by the amount of these costs, even if, for example, the amount is kept by the entity.

Example 7

Further to Example 3, Lily decides to sell her statutory licence to an irrigator outside Waterworks' irrigation district and elects to terminate her access to Waterworks' irrigation network. Upon the subsequent cancellation of her 100 Class B shares (effectively Lily's water delivery right), Waterworks charges Lily a \$150,000 termination fee.

Assume Lily incurs no other costs, Lily would realise a capital loss of \$250,000 from this cancellation.

- This is calculated as follows:
 - The first element of the cost base of her 100 Class B shares is \$100,000.
 - The \$150,000 fee imposed by Waterworks on Lily would be added to the cost base as an incidental cost.
 - Lily receives no capital proceeds and, applying the market value substitution rule, she is taken to receive none.
 - Capital proceeds of \$0 less a cost base of \$250,000 (\$100,000 plus \$150,000) realises a capital loss of \$250,000.

5 Transitional arrangements

This proposal would apply to CGT events that occur on or after 1 July 2008. However, transitional rules would apply to the rules for including termination and exit fees in an asset's cost base as set out in section 4.2.

This is because under the current law, it is possible (but unlikely) that a taxpayer can claim a blackhole deduction for termination or exit fees incurred in relation to a business under section 40-880 of the ITAA 1997. The blackhole deduction allows a taxpayer to deduct eligible capital expenses against ordinary income evenly over five years. These deductions may be more favourable to the taxpayer than including these fees in the relevant asset's cost base.

This proposal would allow taxpayers to include these fees in the relevant CGT asset's cost base, where the fee was incurred after 1 July 2008. This will provide relief for taxpayers unable to claim a blackhole deduction. However, it could retrospectively remove the possibility of claiming a blackhole deduction for some taxpayers. Therefore, from 1 July 2008 until the day before the amending Bill receives Royal Assent taxpayers may have a choice about whether to apply the law allowing them to include termination and exit fees in an asset's cost base.

6 Submissions

We invite interested parties to lodge written submissions on the design of this proposal and whether the proposal would accommodate the different governance arrangements under which 'group' water access licences and entitlements to water under irrigation rights may be held, including through companies, trusts and partnerships. We would also welcome submissions outlining how transformation arrangements may occur.

We also encourage the identification of any other issues, including interaction issues with other parts of the tax law, such as the direct value shifting provisions and the deduction provisions, which may be relevant to the design of this proposal. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.

Some specific questions to consider when preparing submissions include:

- Is the concept of an 'exchange' of assets under a transformation arrangement sufficiently broad to cover the different ways transformation may occur?
- Will all irrigators receive a statutory licence (as defined in the ITAA 1997) under a transformation arrangement, or could the directly held water access entitlement take the form of a different type of asset? Could an irrigator receive multiple assets under the transformation arrangement?
- Could an irrigator have multiple irrigation rights against different operators which are transformed into a single statutory licence (including, for example, a statutory licence that the irrigator already owns)?
- In addition to a statutory licence and any replacement assets, could an irrigator also receive a cash payment under the transformation arrangement? Could an irrigator receive other assets under a transformation arrangement?
- An irrigator's water delivery right may be derived from different assets depending on the facts of a particular arrangement. From what assets could this right be derived from?
- The existing CGT provisions may impose consequences on taxpayers that dispose of pre-CGT shares in a company or pre-CGT interests in a trust – for example CGT event K6 may apply if certain conditions are met. The same conditions that ordinarily trigger these outcomes may arise when an irrigator transforms shares in a company or interests in a trust. What would be an appropriate outcome in these circumstances? Should the same consequences arise as if the irrigator had simply disposed of their shares or interests, or should the consequences be deferred until the irrigator disposes of their individually held statutory licence?
- The CGT consequences for operators will depend on how the transformation arrangement is effected and how their group statutory licence is reduced. Could an operator's group statutory licence be made up of both pre-CGT and post-CGT statutory licences and, if so, is there a need to specify which of the statutory licences are reduced by transformation?
- Consistent with the broad principles set out in the paper, are there alternative ways that an irrigator could calculate the cost base of their water access entitlement? If so, are these calculations simpler than the examples in the paper?

The closing date for submissions is Friday 27 March 2009.

All information (**including name and address details**) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information **marked** as such in a separate attachment. A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Written submissions should be addressed to:

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