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General Manager
Business Tax Division
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Dear Sir/Madam

Submission on the exposure draft package for the tax treatment of water infrastructure improvement payments

We welcome the opportunity to make a submission in relation to the exposure draft package for the proposed reforms to the tax treatment of water infrastructure improvement payments.

Our submission has been prepared after consultation with one of the first and most significant participants in the program. In our submission we highlight that the proposed amendments will give rise to a detrimental tax position for those participants who have a portion of the funding attributable to the disposal of water entitlements. This outcome would appear inconsistent with the changes announced.

Having regard to the additional tax cost that will arise for such participants, we urge the redrafting of the exposure draft to ensure a “no worse off” outcome, or alternatively an exclusion from the changes for those participants who will be adversely impacted.

Importantly, we note that early participants in the program agreed to participate on the basis of the existing taxation laws. Those participants should not be adversely impacted by the changes.

Our submission is in four sections:

1. Purpose of amendments and the “no worse off” principle
2. Impact of the amendments on participants who dispose of water entitlements
3. Alternative approaches
4. Illustrative example (Appendix A)

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1. Purpose of the amendments and “no worse off” principle

The stated intention of the amendments is to eliminate the timing difference between when payments are taxed and when deductions are available for water efficiency investment grants under the Sustainable Rural Water Use and Infrastructure Program (SRWUIP). Further, it is understood that a capital gains tax (CGT) exemption was to form part of the measure.

The original announcement of the changes was positively received by existing and potential participants as they understood the amendments would likely enhance the current tax treatment and by so doing, encourage their further participation.

One of the concerns of participants addressed in the announcement was the timing difference that arises because water facility deductions are to be claimed over a three year period, whereas the funding (adjusted for capital gains) is immediately assessable when derived. We support the objective of eliminating this timing difference. We also support an exemption for any capital gain arising from participating in the program.

However, we note that the amendments go further than simply removing the timing difference and introducing a CGT exemption. The amendments place a significant and unexpected restriction on the amount of water facility deductions available to participants.

“No worse off” principle

As we will show with an illustrated example later, the additional tax cost of the amendments could equate to 10% or more of the total funding available to a participant. This is an unacceptable outcome, especially for early participants who entered the program with a commercial understanding of how the arrangement would be treated under current taxation law.

We urge the redrafting of the provisions to ensure a “no worse off” position for participants. If this can not be achieved, early participants who entered the program on the basis of the existing taxation law should be excluded from the changes so as to preserve their position.

2. Impact of the amendments on participants who dispose of water entitlements

The participants adversely impacted by the current drafting of the amendments are those who have a portion of the funding attributable to the disposal of water entitlements.

Treatment under current taxation law

For those participants, the current tax treatment can be summarised as follows:

<i>Item</i>	<i>Treatment</i>
Funding received	
Amount attributable to disposal of water entitlement	CGT event giving rise to a capital gain or capital loss.
Remaining portion of funding	Fully assessable when derived.
Capital project expenditure	
Water facility costs	Capital expenditure incurred on a water facility may be deductible over 3 years.

Adopting the details from the illustrative example at Appendix A, where the total funding is \$1,000,000, the above treatment can be summarised as follows (ignoring timing differences):

Item	Amount (\$)
Capital gain	75,000
Assessable funding	400,000
<i>Less:</i>	
Water facility deduction	(1,000,000)
Net income/(deduction)	(525,000)

It will be noted from the above illustration that a significant portion of the funding may not be assessable under current taxation law, where CGT treatment is applicable. This is because the amount of the capital gain takes into account such factors as the cost base for acquiring the water entitlements and other reductions and concessions that may be available to the participant, such as the 50% CGT discount.

Further, and importantly, under current taxation law the fact that the assessable capital gain is less than the funding amount attributable to the sale does not reduce the amount of the water facility costs that are deductible.

Illustrative example

We refer you to Appendix A for a full illustrative example of the current taxation treatment. Please note, the figures included in Appendix A are illustrative only and do not represent the figures for any particular participant. Should you require actual figures, we can liaise with a participant who may be willing to provide such details on a strictly confidential basis.

In our illustrative example, the total funding is \$1,000,000 of which \$600,000 is attributable to the sale of water entitlements. The example uses a cost base (purchase price) of the water entitlements of \$450,000 and assumes the participant is a trust and eligible for the 50% CGT discount.

Impact of the amendments

Under the proposed amendments all the assessable and deductible amounts will be reduced to nil. The consequence of this treatment in the example is a forgone net deduction over the relevant period of \$525,000 and an estimated additional tax cost of \$156,375.

In this example the additional tax cost of the amendments represents more than 15% of the total funding. Such an outcome is unacceptable to participants and would appear to be an unintended consequence of the proposed changes.

Preserving the water facility deduction for expenditure funded from the sale of water entitlements

As noted above, under current taxation law the fact that the assessable capital gain is less than the funding amount attributable to the sale does not reduce the amount of the water facility costs that are deductible.

We submit that this position is both fair and reasonable and should be preserved for reasons including:

- It reflects a sound commercial understanding of the transaction entered by the participants whereby water entitlements have been sold at fair value and those monies have in turn been used to fund part of the water efficiency project.
- The water entitlements are an asset of the participant which they have previously acquired. The purchase price will represent an investment (often from after tax monies) with a cost base for tax purposes. Participants should not be required to forgo the tax benefit associated with the tax base of their investment by preventing them having a deduction for reinvesting it in water facility costs under the program.
- The participants water facility deductions should be treated consistently with any other water facility costs that are funded from the sale of other assets (outside the program). In that case the participant pays any capital gains tax on the asset sold and will be entitled to a deduction for their new water facility costs.
- The amount of the funding attributable to the water entitlements disposed of is distinguishable from the remaining portion of the funding received which is an “additional” amount over and above the value of the asset transferred. (We accept that if the additional amount is non assessable the deductions may be reduced accordingly as a mechanism to eliminate the timing difference, however the deductions should not be reduced any further than the “additional” amount).

3. Alternative approaches

The proposed changes announced appear to have had two intended outcomes, being:

- Removing the timing difference for when payments are taxed and when deductions are available; and
- Providing a CGT exemption.

We submit that that the timing difference referred to in the announced changes is only relevant to the extent that the amount taxed and the deduction allowed are equal. Where the deduction exceeds the amount that is assessable, this would not constitute a timing difference but rather a quantum difference. It would not appear to be consistent with the announced changes to reach beyond the timing difference and reduce the value of deductions available to participants.

Option 1: Preserving a deduction for expenditure funded from amounts attributable to the disposal of water entitlements

The amendments would become consistent with our understanding of the announcements with the following modification:

- Limit the application of the proposed section 26-100 so that it does not apply to expenditure reasonably attributable to that component of the payments which forms part of the capital proceeds of a CGT event.

Adopting the figures in our example, the amount of funding attributable to the capital proceeds of a CGT event would be \$600,000. Therefore section 26-100 would only apply to limit the deduction up to \$400,000 being the amount that is not attributable to capital proceeds.

Option 2: Preserving a deduction for amounts of the funding that were not otherwise assessable

If it is intended that no deduction be available for expenditure that is reasonably attributed to the exempt capital gain, then a further modification may be required. That modification should only apply to the otherwise assessable component of the capital gain after applying any reductions or concessions that would be available. That is to say, it would be restricted to potential timing differences.

Adopting the figures in our example, section 26-100 would apply to limit the deduction up to \$475,000. This amount comprises \$400,000 being the amount of the assessable funding that is not attributable to capital proceeds and \$75,000 being the otherwise assessable capital gain that has been disregarded.

We also note that we support the treatment of the total payments as 'non assessable non exempt' income. If this position is altered in the final drafting, then we suggest appropriate amendments to section 104-71 *Income Tax Assessment Act 1997* to ensure the benefit of the gain being disregarded can be passed through to beneficiaries/unit holders, in the case where a trust is the participant.

Option 3: Excluding early participants from the changes

Where the adverse tax implications outlined in this submission are not otherwise resolved, then it is requested that those participants adversely impacted be excluded from the changes. We will be pleased to liaise with you to ensure those participants we are aware of can be excluded, such as by removing one or more of the programs from the list of eligible programs.

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Should you wish to discuss any details of this submission, please do not hesitate to contact me on +61 7 4616 3017.

Yours sincerely



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Appendix A – Illustrative example of adverse tax implications for participants with a portion of the funding attributable to the disposal of water entitlements

Assumptions							
Total funding	\$1,000,000						
- Fair value of water entitlements	\$600,000						
Cost base of water entitlements transferred	\$450,000						
Water facility capital expenditure ¹	\$1,000,000						
Entity type	Trust						
50% CGT discount available	Yes						
1. The amount of the expenditure may have exceeded this amount. However, the excess is not impacted by the changes.							
Transaction summary							
	Year -X	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Inflows							
Proceeds on sale of water entitlement	-	-	600,000	-	-	-	600,000
Remaining portion of funding	-	-	-	400,000	-	-	400,000
Outflows							
Purchase of water entitlement	(450,000)	-	-	-	-	-	(450,000)
Qualifying project capital costs	-	(200,000)	(500,000)	(300,000)	-	-	(1,000,000)
	(450,000)	(200,000)	100,000	100,000	-	-	(450,000)
Taxation treatment under existing rules							
Taxation treatment							
	Year -X	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Assessable							
Discounted capital gain	-	-	75,000	-	-	-	75,000
Remaining portion of funding (grant monies)	-	-	-	400,000	-	-	400,000
Deductible							
Water facility deduction	-	(66,667)	(233,333)	(333,333)	(266,667)	(100,000)	(1,000,000)
	-	(66,667)	(158,333)	66,667	(266,667)	(100,000)	(525,000)
Tax effect (assuming effective tax rate of 31.5% for gain and 30% for other items)							
	Year -X	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Tax cost of assessable items							
Discounted capital gain	-	-	(23,625)	-	-	-	(23,625)
Remaining portion of funding (grant monies)	-	-	-	(120,000)	-	-	(120,000)
Tax benefit of deductible items							
Water facility deduction	-	20,000	70,000	100,000	80,000	30,000	300,000
Tax benefit/(cost)	-	20,000	46,375	(20,000)	80,000	30,000	156,375
Taxation treatment under proposed changes							
Under the proposed amendments the above tax benefit will be reduced to nil resulting in an additional tax cost of \$156,375.							

The figures included in this example are illustrative only and do not represent the figures for any particular participant.