
Chapter 1

Water infrastructure improvement payments

Outline of chapter

1.1 Schedule # to this Bill amends Divisions 26, 59 and 118 of the *Income Tax Assessment Act 1997* (ITAA 1997) to allow Commonwealth payments made under the Sustainable Rural Water Use and Infrastructure program (SRWUIP) to be received by program participants free of income tax (including capital gains tax (CGT)) in certain circumstances, with related expenditures being non-deductible.

Context of amendments

1.2 On Friday 18 February, 2011, the Government announced that it would amend the taxation laws to eliminate the timing mismatch between when the SRWUIP payments are taxed and when deductions are available, and that a CGT exemption would form a part of the measure.

1.3 The amendments achieve this by eliminating the tax and the deductions.

SRWUIP

1.4 SRWUIP is a major component of the Government's *Water for the Future* program. SRWUIP payments are used to upgrade irrigation and other rural infrastructure in order to improve efficiency and productivity of rural water use and management, to deliver substantial and lasting water returns to the environment and to help secure a long-term sustainable future for irrigated agriculture.

1.5 SRWUIP consists of a broad suite of programs, often delivered in partnership with state/territory governments, who may provide supplementary funding.

1.6 SRWUIP payments are made under agreements between the Commonwealth and other parties, who may include state governments, irrigation infrastructure operators (IIOs) and individual irrigators. A project participant who is the ultimate recipient of a payment will use that

money to undertake specified works, either themselves or by contracting out the work.

1.7 Some SRWUIP projects entail an agreement by an IIO or irrigator to share water efficiency savings with the Commonwealth, by the transfer to the Commonwealth of some of the pre-existing water entitlement. Where the increase in water use efficiency from such SRWUIP-funded projects means that less water needs to be diverted to achieve the existing amount of irrigated production, water entitlements can be transferred to the Government without causing a reduction in irrigated production. The Commonwealth can then use the transferred entitlements for environmental watering activities.

Taxation timing of SRWUIP

1.8 In the absence of these amendments, payments under SRWUIP would generally be taxable in the year they are received, either as ordinary income or as a subsidy, or (to the extent that a payment is deemed consideration for the supply of any transferred water rights) capital gains. However, for the most part, expenditure under the program would be deductible over three years, under Subdivision 40-F ITAA 1997, as water facilities used in primary production.

Summary of new law

1.9 This Schedule makes qualifying water infrastructure improvement payments free from income tax (as 'non-assessable non-exempt income' (NANE)), including CGT. Expenditures are denied deductions to the extent that they are funded by such payments.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Qualifying water infrastructure improvement payments are NANE.	SRWUIP payments could be taxable for certain entities, in the year they are received, either as ordinary income or as a subsidy.
Expenditures are denied deductions to the extent that they are funded by qualifying water infrastructure improvement payments.	Expenditures could be deductible, either in the year they are incurred or over time.
Capital gains or losses made, in relation to water entitlements, from a CGT event that happens because of a qualifying water infrastructure improvement payment are disregarded.	Part of a SRWUIP payment could be taxable as a capital gain or loss that you make from a CGT event relating to water entitlements.
Capital gains or losses made from a CGT event relating to the receipt of a qualifying water infrastructure improvement payment are disregarded.	Part of a SRWUIP payment could be taxable as a capital gain or loss that you make from a CGT event relating to the receipt of the payment.

Detailed explanation of new law

Qualifying payments

1.10 Not all payments received under the Commonwealth SRWUIP will qualify for the tax treatment afforded by these amendments. In the amendments, ‘qualifying water infrastructure improvement payment’ is a defined term, confined to amounts that, in the hands of a particular recipient, qualify for the special tax treatment. A payment will be such a qualifying payment to the extent that it meets the tests outlined below. *[Item 3, subsection 59-65(2) and item 5]*

Commonwealth-sourced SRWUIP payment

1.11 A qualifying payment must be received under the Commonwealth program known as the Sustainable Rural Water Use and Infrastructure program. SRWUIP is administered by the Department of Sustainability, Environment, Water, Population and Communities (SEWPaC). *[Item 3, subsection 59-65(2), subsection 59-65(4) and item 6]*

1.12 A SRWUIP payment will only be a qualifying payment to the extent that it originates from the Commonwealth. *[Item 3, subsection 59-65(2)]*

1.13 Although a qualifying payment can be delivered through a state government (or other entity), possibly supplemented by additional amounts, the amount received by the ultimate recipient will only be a qualifying payment to the extent that the amount is reasonably attributable to a payment made by the Commonwealth. *[Item 3, paragraph 59-65(2)(b)]*

Received in relation to an eligible SRWUIP program

1.14 Qualifying payments will be received by a participant in an eligible SRWUIP program. This may entail a SRWUIP payment retaining the status of a qualifying payment at one of more links of a chain of participants. Documentation in relation to project agreements would generally indicate the SRWUIP program and the extent to which payments are sourced from the Commonwealth. Although a qualifying payment must be received under the terms of an agreement involving the Commonwealth, a project participant can receive a qualifying payment without being a party to the agreement with the Commonwealth. However, payment for performing work under a contract with a project participant would not, of itself, be a qualifying payment. *[Item 3, subsection 59-65(2)]*

Example 1.1: Qualifying payment: chain of program participants

The Commonwealth provides \$10m to State Government as part of an agreement between the Commonwealth and the State to reduce channel leakage under an eligible SRWUIP program.

State Government forwards the \$10m to IIO under an agreement between State Government and IIO for a project to reduce leakage from various on-farm and off-farm channels in their irrigation area.

Under that agreement (and consistent with the Commonwealth's agreement with State Government) IIO spends \$100,000 on preparatory work and contracts with Local Earthworks Company to perform \$2.4m of works on the off-farm channels and provides \$2.5m each to three irrigators in the area under agreements between IIO and the respective irrigators (who operate as sole traders) to perform specified works on their respective on-farm channels. Under those agreements, it is up to the individual irrigators to determine how the agreed works are to be completed.

Handy Irrigator performs the works on his own farm using his own labour (including farm employees) and equipment and materials he purchases. Cousin Irrigator contracts Handy Irrigator to perform the works on Cousin's farm (at arm's length prices). Busy Irrigator contracts Another Earthworks Company to conduct the works on Busy's farm.

All of the \$10m received by IIO would be a qualifying payment in the hands of IIO, because it was received as an amount reasonably attributable to a SRWUIP payment made by the Commonwealth and in IIO's capacity as a participant in an eligible program.

All of the \$2.5m amounts received by the respective irrigators (Handy Irrigator, Cousin Irrigator and Busy Irrigator) from IIO would be qualifying payments in their hands, because they were received as an amount reasonably attributable to a SRWUIP payment made by the Commonwealth and in their capacity as a participant in an eligible program.

However, the amount received by Handy Irrigator for his work on Cousin Irrigator's farm would not be a qualifying payment, as it was received in his commercial capacity as a provider of earthworks rather than in his capacity as a program participant. Similarly, the amount received by Local Earthworks Company from IIO and by Another Earthworks Company from Busy Irrigator, and the amounts received by Handy Irrigator's employees and suppliers, would not be qualifying payments.

Recovery by the Commonwealth of a qualifying payment

1.15 In the event that the Commonwealth seeks to recover some or all of a SRWUIP payment, to that extent the payment will be treated as if it never were a qualifying payment. This would have the effect of the normal tax treatment applying in relation to that payment and any related deductions and CGT events. *[Item 3, subsection 59-65(3)]*

1.16 The Water Secretary must notify the Commissioner about payments that the Commonwealth seeks to recover. *[Item 3, section 59-75]*

Eligible SRWUIP programs

1.17 Qualifying payments will be in relation to projects conducted under programs that have been publicly listed as eligible SRWUIP programs. *[Item 3, subsection 59-65(2)]*

1.18 Having a list of eligible SRWUIP programs provides clarity to administrators and taxpayers as to which projects attract the special tax treatment.

Listing of eligible SRWUIP programs

1.19 The list of eligible SRWUIP programs is maintained by the 'Water Secretary', who is the Secretary of the Water Department, which deals with the *Water Act 2007* (SEWPaC). The list must be published on the Water Department's website. *[Item 3, subsection 59-70(1) and item 7]*

1.20 Additions to the list are initiated by the 'Water Minister', who is the Minister administering the *Water Act 2007* (the Minister for Sustainability, Environment, Water, Population and Communities). The Water Minister notifies the Minister administering the ITAA 1997 (the Treasurer) that a SRWUIP program meets certain criteria. *[Item 3, subsection 59-70(3)]*

1.21 The Treasurer and Water Minister then have the discretion to direct, in writing, the Water Secretary to include the SRWUIP program on the list, having regard to the policies and budgetary priorities of the Commonwealth Government. *[Item 3, subsections 59-70(2),(4)&(7)]*

1.22 The direction must specify the period covered by the listing. The period can be the interval between two dates or an open ended period commencing on a certain date. A listing can be retrospective, subject to the relevant payments having been made by the Commonwealth on or after 1 April 2010. *[Item 3, subsection 59-70(4) and Item 8]*

1.23 The period can be changed by a further direction, in writing, from the Ministers that has the effect of either lengthening the period (including retrospectively) or prospectively closing off a previously open-ended period. [Item 3, subsections 59-70(5)&(6)]

Eligibility criteria for listing SRWUIP programs

1.24 The Water Minister may only propose a program for listing where he or she is satisfied that the program is a SRWUIP program that will generate efficiencies in water use through infrastructure improvements. However, the requirement that the SRWUIP program's projects entail infrastructure improvements doesn't confine the special tax treatment to the part of the qualifying payment that is applied to capital expenditure. Nor do the requirements on Ministers impose similar requirements on recipients of SRWUIP payments — the eligibility of a particular project is determined by it being conducted under a program that is publicly listed as an eligible SRWUIP program. [Item 3, subsection 59-70(3)]

The special tax treatment

1.25 Qualifying payments are subject to a special tax treatment.

Qualifying payments are received free of income tax

1.26 A qualifying payment is 'non-assessable non-exempt income' (NANE). This means that a qualifying payment is not counted in working out taxable income and has no effect on tax losses. (In contrast, 'exempt income', although not counted in working out taxable income, will reduce a taxpayer's tax losses before any such losses can be used to offset assessable income). NANE treatment is therefore more favourable to the taxpayer than making an amount exempt income. [Item 1 and Item 3, subsection 59-65(1)]

Qualifying payments have no CGT consequences

1.27 Where SRWUIP projects entail an agreement by an IIO or irrigator to transfer to the Commonwealth some of their pre-existing water entitlement, part of the SRWUIP payments would generally be regarded as consideration for the transfer. This would be a CGT event, with a potential capital gain or loss with tax implications. The amendments in the schedule ensure that a capital gain or loss that you make from such a CGT event is disregarded. [Item 4, paragraph 118-37(1)(ga)]

1.28 In some circumstances, the receipt of a SRWUIP payment can itself constitute a CGT event. The amendments ensure that a capital gain

or loss that you make from such a CGT event is disregarded. *[Item 4, paragraph 118-37(1)(gb)]*

Expenditures funded by qualifying payments are non-deductible

1.29 Expenditure that is reasonable attributable to a qualifying payment is denied a tax deduction. This avoids a ‘double benefit’ arising from the qualifying payment being NANE. Where a qualifying payment is used for capital expenditure, the deductions denied will be those that would otherwise arise in relation to the expenditure under Division 40 (depreciating assets, including section 40-515 primary production water facilities), Division 43 (capital works) and Division 328 (small business entities) of the ITAA 1997. *[Item 2]*

1.30 The non-deductibility only applies to expenditure that is reasonably attributable to a qualifying payment. This provision would not deny a deduction for expenditure on the project that is instead attributable to other sources — such as a state government, an IIO, or an irrigator.

Amendment of assessments

1.31 A taxpayer’s assessment can be amended to give effect to additions to the published list of eligible programs (including the initial listing of eligible programs) or in relation to the Commonwealth seeking to recover amounts, regardless of when the original assessment was made. Such amendments to assessments must be made within four years of the change to the list being published or of the Commonwealth seeking to recover amounts. *[Item 3, section 59-80]*

1.32 Such amendments to assessments could entail:

- an amount that had originally been treated as assessable income being instead treated as NANE (or vice versa);
- an amount that had originally been deducted being instead treated as non-deductible (or vice versa); or
- an amount that had been treated as a capital gain or loss being treated as not being so (or vice versa).

Application and transitional provisions

1.33 The schedule applies in relation to payments made by the Commonwealth on or after 1 April 2010. *[Item 8]*

