

FEDERAL COURT OF AUSTRALIA

Victoria Power Networks Pty Ltd v Commissioner of Taxation [2020]

FCAFC 169

- Appeal from: *Victoria Power Networks Pty Ltd v Commissioner of Taxation* [2019] FCA 77
- File numbers: VID 237 of 2019
VID 238 of 2019
VID 239 of 2019
VID 240 of 2019
- Judgment of: **LOGAN, COLVIN AND THAWLEY JJ**
- Date of judgment: 21 October 2020
- Catchwords: **TAXATION** – assessable income – income according to ordinary concepts – non-cash business benefits – where electricity distributors were required to connect customers to the electricity network upon request – where the connection works were carried out either by the distributor or by the customer – where, in relation to the first situation, if the connection was “uneconomic”, the customer paid a cash contribution to the distributor – whether the cash contribution was income according to ordinary concepts – where, in relation to the second situation, the customer was required to transfer the relevant assets to the distributor and received a rebate from the distributor – where, in relation to that situation, if the connection was “uneconomic”, the rebate was the estimated cost of construction less a customer contribution – whether the customer contribution was income according to ordinary concepts – whether the transferred assets constituted a non-cash business benefit – consideration of the amount to be included in the distributor’s assessable income pursuant to s 21A of the *Income Tax Assessment Act 1936* (Cth) – consideration of the arm’s length value of the transferred assets
- Legislation: *Income Tax Assessment Act 1936* (Cth) ss 21A, 136AA
Income Tax Assessment Act 1997 (Cth) s 6-5, subdiv 20-A
Electricity Industry Act 2000 (Vic)
- Cases cited: *Boyce (H.M. Inspector of Taxes) v Whitwick Colliery Co Ltd* (1934) 18 T.C. 655; [1934] All E.R. Rep 706
Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation (2017) 251 FCR 40

Federal Commissioner of Taxation v Consolidated Media Holdings Ltd (2012) 250 CLR 503
Federal Commissioner of Taxation v Myer Emporium Ltd (1987) 163 CLR 199
G.P. International Pipecoaters Pty Ltd v Federal Commissioner of Taxation (1990) 170 CLR 124
Glenboig Union Fireclay Co Ltd v Commissioners of Inland Revenue 1922 SC (HL) 112; 12 TC 427
Hallstroms Pty Ltd v Federal Commissioner of Taxation (1946) 72 CLR 634
Inland Revenue Commissioners v British Salmson Aero Engines Ltd [1938] 2 KB 482
Scott v Federal Commissioner of Taxation (1966) 117 CLR 514
Spencer v The Commonwealth (1907) 5 CLR 418
Steele v Deputy Commissioner of Taxation (1999) 197 CLR 459
Victoria Power Networks Pty Ltd v Commissioner of Taxation [2019] FCA 77

Division: General Division
Registry: Victoria
National Practice Area: Taxation
Number of paragraphs: 126
Date of hearing: 21 August 2020
Counsel for the Appellant: Mr J Hmelnitsky SC with Ms L Hespe
Solicitor for the Appellant: King & Wood Mallesons
Counsel for the Respondent: Mr G Davies QC with Ms J Jaques and Mr L Molesworth
Solicitor for the Respondent: MinterEllison

ORDERS

VID 237 of 2019
VID 238 of 2019
VID 239 of 2019
VID 240 of 2019

BETWEEN: **VICTORIA POWER NETWORKS PTY LTD**
Appellant

AND: **COMMISSIONER OF TAXATION**
Respondent

ORDER MADE BY: **LOGAN, COLVIN AND THAWLEY JJ**

DATE OF ORDER: **21 OCTOBER 2020**

THE COURT ORDERS THAT:

1. Each appeal be allowed in part.
2. The orders made in the original jurisdiction on 25 February 2019 be set aside.
3. In lieu thereof and in respect of each taxation appeal, it be ordered that:
 - (a) the appeal against the respondent's objection decision be allowed in part and the matter remitted to the respondent for amendment of the assessment concerned on the footing that the arm's length value of the infrastructure assets transferred for the purposes of s 21A(2) of the *Income Tax Assessment Act 1936* (Cth) was the amount of the Rebate paid by each respective appellant (each respective distributor) to the customer; and
 - (b) save as provided by sub-paragraph (a), the appeal be dismissed.
4. The parties file and serve, not later than seven days from the date hereof, either a consent in respect of costs of and incidental to the appeals and each of the taxation appeals or, failing consent, their respective submissions of not more than 5 pages as to the order sought in respect of costs, following or in default of which the Court will determine on the papers the order as to costs which ought be made.
5. Pending the determination of costs either by consent or as provided for by this order, all questions in respect of costs of each appeal and in the original jurisdiction be reserved.

Note: Entry of orders is dealt with in Rule 39.32 of the *Federal Court Rules 2011*.

REASONS FOR JUDGMENT

LOGAN J:

- 1 I have had the privilege of reading in draft the reasons for judgment to be delivered by Colvin J. There was no challenge of any moment to the detailed findings of fact made by the learned primary judge. I incorporate by reference but do not repeat those detailed findings. I also gratefully adopt the summary offered by Colvin J, including the abbreviations used. His Honour has also extracted, to the extent necessary, the pertinent legislation and summarised the submissions of the parties.
- 2 I agree with Colvin J, for the reasons his Honour gives, and thus with the learned primary judge, that the Customer Cash Contributions received under Option 1 were ordinary income. I likewise agree with Colvin J, and thus in this regard also with the learned primary judge, contrary to the Commissioner's notice of contention, that Option 2 did not result in any derivation of income under ordinary concepts.
- 3 As to the s 21A issue concerning Option 2, I also agree with Colvin J, for the reasons his Honour gives, and thus respectfully differ from the learned primary judge, as to the outcome in relation to that issue.
- 4 Because, as to s 21A, we are differing from a carefully reasoned view expressed in the original jurisdiction in relation to a provision the meaning of which has not hitherto received detailed consideration at intermediate appellate level and also in deference to the persuasive submissions of counsel generally, I wish to add the following additional reasons.

THE OPTION 1 S 6-5(1) ISSUE

- 5 In *Inland Revenue Commissioners v British Salmson Aero Engines Ltd* [1938] 2 KB 482, at 498, Lord Greene MR observed of the, even by then, many cases where the subject of capital or income had been debated that, "There have been many cases which fall on the border-line. Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons". In *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 (*Hallstroms*), at 646, Dixon J, having referred to this observation, stated:

For myself, however, I am not prepared to concede that the distinction between an expenditure on account of revenue and an outgoing of a capital nature is so indefinite and uncertain as to remove the matter from the operation of reason and place it

exclusively within that of chance, or that the *discrimen* is so unascertainable that it must be placed in the category of an unformulated question of fact. The truth is that, in excluding as deductions losses and outgoings of capital or of a capital nature, the income tax law took for its purposes a very general conception of accountancy, perhaps of economics, and left the particular application to be worked out, a thing which it thus became the business of the courts of law to do.

- 6 *Hallstroms* was a case where the question was whether expenditure was on revenue or capital account, whereas the present, in terms of the issue arising in relation to s 6-5(1) of the *Income Tax Assessment Act 1997* (Cth) (**ITAA1997**), is whether certain receipts are income under ordinary concepts, termed, “ordinary income” or of a capital nature. As to this question also, the truth is that s 6-5(1) of the ITAA1997, by including as assessable income what is termed “ordinary income”, likewise “took for its purposes a very general conception of accountancy, perhaps of economics, and left the particular application to be worked out, a thing which it thus became the business of the courts of law to do”.
- 7 It is in the nature of the business of the courts to work out the outcome on particular facts of general principles. An alternative is to opt either for arbitrariness or for prescriptive codification. The former is apt to seem unjust on particular facts, the latter usually futile but unfortunately all too prevalent in modern legislation, in an endeavour to anticipate in advance every possible permutation and combination of facts produced by human ingenuity, passion, guile and acumen. All too often, the price of the latter endeavour is just a Byzantine thicket, penetrable, if at all, only by a select few. That is not to say that judicial application of a general principle is always attended with precise predictability, only that the principle itself is more likely, readily and generally, to be comprehensible and its application not arbitrary but specific to the facts of an individual case.
- 8 The giving of finality to a controversy by the exercise of judicial power is a desirable attribute of that power, conducive to preserving peace and order in a society governed by the rule of law. Provision for this in relation to taxation controversies is also a concomitant of legislative competence in relation to laws imposing taxation. However, another truth is that this finality can lend in hindsight an appearance of certainty of outcome to a controversy that may never, quite reasonably, have been present in prospect. This is often so when the subject of debate is income or capital. *Hallstroms* offers an excellent example of this. The outcome in that case was determined by a bare majority (3-2) and Dixon J was a member of the minority. A plethora of other examples of sharp differences of views might be cited in respect of the income versus capital distinction on both the revenue and expenditure sides of the ledger. It is just the way of

things. As Kirby J memorably observed in his dissent in *Steele v Deputy Commissioner of Taxation* (1999) 197 CLR 459, at [71], “there is no point in complaining”.

9 These thoughts, hardly novel, were provoked strongly by the nature of the controversy in relation to Option 1, the high quality of the submissions, both for VPN and the Commissioner, in this case and, as will be seen, by an error identified by the High Court in the reasoning of a persuasive authority that supports VPN’s submissions.

10 The relevant, overarching *discrimen* was succinctly and accurately, but with deceptive simplicity, expressed by Windeyer J in *Scott v Federal Commissioner of Taxation* (1966) 117 CLR 514, at 526, “Whether or not a particular receipt is income depends upon its quality in the hands of the recipient”.

11 As to the applicable quality of the Customer Cash Contributions upon their receipt, VPN’s submission took up a principle, approved by reference to earlier authority, in *G.P. International Pipecoaters Pty Ltd v Federal Commissioner of Taxation* (1990) 170 CLR 124 (***G.P. International Pipecoaters***), at 142. That principle is that a receipt is on capital account “when the amount is received by way of gift or subsidy to replenish or augment the payee’s capital, for in such a case the receipt cannot fairly be said to be a product or incident of the payee’s income-producing activity”.

12 VPN put that this principle was applicable in the present case such that the Customer Cash Contribution was a receipt of capital. That was because, so it submitted, under the regulatory regime, customers were required to subsidise (that is, assist) the capital cost of connection works to the extent of the Customer Cash Contributions. It followed, it submitted, that those contributions were not paid to a distributor either as a reward for the construction of connection works or as a remuneration for performing a service.

13 There is, however, a caveat to this principle, which is that “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”: *G.P. International Pipecoaters*, at 142.

14 Whether the caveat is applicable is but an incident of a wider requirement. That requirement is to identify the scope of a business and its operator’s purpose of engaging in it as a means of

determining the character of a receipt in the hands of its recipient: *Federal Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199, at 209 – 210.

- 15 The scope of each distributor’s business was the supply to customers of electricity distribution services at a profit.
- 16 To the end of assuring electricity distribution to customers and preventing monopoly behaviour and related excessive profits, the market in which the distributors carried on business was closely regulated. Materially, that regulation included the requirement to adhere to the Guideline. Nonetheless, that did not alter the scope of each distributor’s business. In order to distribute electricity to a new customer, the distributors needed not just to have the requisite additional network infrastructure but also to operate and maintain it.
- 17 The alternative of an Option 1, Customer Cash Contribution only arose where, in relation to a new connection to the distribution network, the incremental revenue was less than the incremental cost, each as calculated in accordance with the Guidelines. Under the Guidelines, the incremental cost was not just the estimated cost of undertaking the works to connect the customer to the distribution network. It also included operating and maintenance costs in respect of the connection over its estimated life.
- 18 The distributors received the Customer Cash Contribution as part of the monetary consideration payable for providing an electricity distribution service. That contribution, as was always intended by its undissected components, was just part of a distributor’s general revenue in the conduct of its distribution business out of which it funded new infrastructure and the cost over time of operating and maintaining that infrastructure.
- 19 Once the scope of a distributor’s business is understood, a flaw in VPN’s submission is the same as that identified in *G.P. International Pipecoaters*, at 142 – 145, in relation to the reasoning and outcome in *Boyce (H.M. Inspector of Taxes) v Whitwick Colliery Co Ltd* (1934) 18 T.C. 655; [1934] All E.R. Rep 706 (*Boyce*). A good way of highlighting that flaw is to paraphrase and apply in the present context the High Court’s criticism in that case, at 144, of *Boyce*. 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.

20 To hold otherwise would be to commit the vice of determining the character of a distributor's receipts by the character of one of the expenditures it makes from those receipts in order to carry on its electricity distribution service business. That the latter may be capital expenditure does not mean that a receipt into general revenue from which that expenditure is funded is a receipt on capital account.

21 The Customer Cash Contributions were neither received as the price of a capital asset nor as a payment dissociated from a distributor's business. They were received as part of the remuneration earned by the carrying on by a distributor of its business, which consisted of the supply to a customer of an electricity distribution service, entailing, amongst other things and as necessary, the distributor having, operating and maintaining the requisite network infrastructure. They were therefore income under ordinary concepts and therefore ordinary income which, by s 6-5(1) of the ITAA1997, formed part of assessable income.

SECTION 21A ISSUE

22 When a customer chose Option 2 and constructed particular contestable works infrastructure necessary for a new connection, that infrastructure was transferred to the distributor by the customer upon the connection being tied in to the distribution network. Assuming Option 2 did not result in any derivation of income under ordinary concepts, it is common ground between the parties that the transferring of the infrastructure asset to the distributor constituted the derivation by that distributor of income in the form of what s 21A of the *Income Tax Assessment Act 1936* (Cth) (**ITAA1936**) terms a "non-cash business benefit".

23 The effect of s 21A(2)(a) of the ITAA1936 is that this "non-cash business benefit" is required to be brought into account in the distributor's assessable income "at its arm's length value, reduced by the recipient's contribution (if any)". The term "arm's length value" is defined by s 21A(5) of the ITAA1936.

24 The s 21A aspect of the controversy concerns the construction and application of the definition of "arm's length value". The parties are agreed that it is practical to determine an amount such that it is not a case where the Commissioner, pursuant to s 21A(5)(b) of the ITAA1936, was to determine an amount he considered reasonable.

25 We must, as the High Court is wont to remind, begin with a consideration of the statutory text:
Federal Commissioner of Taxation v Consolidated Media Holdings Ltd (2012) 250 CLR 503,
at [39].

26 An analysis of the text of s 21A(5)(a) of the ITAA1936 discloses that the calculation of the
amount requires the following to be identified. The first is the recipient. The second is the
benefit. The third is *the* provider. The fourth is the amount *that* recipient could reasonably be
expected to have been required to pay to obtain *that* benefit from *that* provider “under a
transaction where the parties to *the* transaction are dealing with each other at arm's length in
relation to the transaction”. The emphasis I have given reflects the use of the definite article in
the text.

27 The use of the indefinite article, “a” to govern “transaction” where first appearing, in
conjunction with “could reasonably be expected” and “at arm’s length”, shows that it is not the
very transaction between the parties in respect of the benefit which yields the amount. The test
is objective.

28 Even though the test is objective, that does not render the identity of either the recipient, the
benefit or the provider irrelevant. That flows textually from the use of the definite article, not
the indefinite article, to govern each.

29 In my view, the reasonable expectation must be formed by reference to a recipient which is an
electricity distributor, a customer who is a new customer for supply from that distributor and
the benefit must be the requisite electricity infrastructure to enable that supply to occur.
Inserting the identified relevant parties and infrastructure into the text of s 21A(5)(a), the
question becomes, “What is the amount that the distributor (the recipient) could reasonably be
expected to have been required to pay to obtain the infrastructure in the form of the contestable
works (the benefit) from the customer who has selected Option 2 (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?”

30 All of this points to an expectation that takes account of the market in which they must deal in
order for the benefit to be transferred and the price that the distributor could reasonably be
expected to pay in an arm’s length dealing with the customer. Put another way, the formula for
the calculation of the amount, although objective, is not divorced from the market in which the

parties must necessarily deal with each other in order for the benefit to be transferred to the recipient.

31 What follows from this textual analysis is that I accept VPN’s submission that “arm’s length value” “is defined in s 21A(5)(a) in terms which require a consideration of the position of the actual recipient and not some notional ‘independent party’”. VPN’s point that the text of s 21A(5) of the ITAA1936 is different to that of (the since repealed) s 136AA(3)(d) of the ITAA1936, considered in *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation* (2017) 251 FCR 40, at [44] and [119], is a good one in this sense. There is a level of abstraction and conjecture posited by the reasonable expectation, at arm’s length test in s 21A(5)(a) but it still looks to the character or status of the actual parties and to the market in which such parties must deal.

32 That being so, it seems to me a modified form of the classic, general valuation question posited by Griffith CJ in *Spencer v The Commonwealth* (1907) 5 CLR 418, at 432, is posited by the text of s 21A(5)(a). Inserting s 21A(5)(a) requirements in that test, it becomes, “What, in the regulated market in which they were obliged to deal one with the other, would a distributor desiring to buy the infrastructure asset have had to pay for it on that day to a customer willing to sell it for a fair price but not desirous to sell it?” That is but another way of posing the question derived from textual analysis.

33 Either way derivatively formulated, the test focuses on what the recipient, here the distributor, could reasonably be expected to pay.

34 On the evidence, the market in which a new customer provider and a distributor recipient must deal is regulated via, materially, the Guideline. There has never been any suggestion that the distributors dealt with customers other than at arm’s length.

35 It follows, in my view, that, in the circumstances of the present case, a reasonable expectation must be informed by the terms on which, in relation to Option 2, distributor and customer did deal. Put shortly, objectively, a price reasonably to be expected is *the* price paid by the distributor. That does not substitute an actual dealing for the required objective, conjectural dealing. All it does is recognise that the best evidence on which to base a reasonable expectation is the result of the behaviour of arm’s length parties in the relevant market.

36 The finding of the learned primary judge, at [179], was that, the distributor offered to pay the customer an amount (the Rebate) calculated as the estimated cost of construction less the

Customer Contribution. The customer accepted that offer. It was on those terms in the regulated market that the infrastructure asset was transferred to the distributor by the new customer who had chosen Option 2. It was on those terms that the distributor paid for that infrastructure.

37 An Option 2 transaction is, as VPN correctly submitted, on very different terms to an Option 1 transaction.

38 The error made by the learned primary judge and by the Commissioner was, with respect, not to appreciate the focus dictated by the text of s 21A(5)(a). That “focus”, as VPN correctly submitted, cannot exclude what, in the market concerned, the distributor would be willing to pay for the infrastructure asset. The terms of the transaction between the parties as found by the primary judge reflects this.

39 That transaction accords, unsurprisingly, with a rational business judgement on the part of a distributor.

40 Where the required infrastructure for a new connection is not expected to generate incremental revenue sufficient to cover the incremental costs associated with that connection (ie where the incremental cost is greater than the incremental revenue), it is not reasonable to expect that the distributor could be required to pay an amount equal to the estimated cost of construction of that infrastructure to obtain the benefit of that infrastructure.

41 Equally, and from the perspective of the customer, in an Option 2 situation, it has already agreed itself to bear the cost of the construction of the required new infrastructure so as to obtain the connection to the network. In this market, having notified the distributor it chose to take up Option 2, the greatest benefit the customer could expect from the transfer of the infrastructure asset to the distributor is the Rebate. As VPN correctly submitted, “The Rebate is the amount the distributor could reasonably be expected to pay to obtain the benefit of the connection assets because the Rebate represents the extent to which the expected revenues from the connection will cover the expected costs associated with the connection”. In this market, in these Option 2 circumstances, no distributor could reasonably be expected to pay more than that for the new infrastructure. Proof perfect of that is the finding of fact made by the learned primary judge. The Rebate happens to be the price actually paid by arm’s length parties in an Option 2 situation for the infrastructure.

42 It is nothing to the point that, in their Option 2 dealings, one component of the calculation of the Rebate is the estimated cost of the construction of the new infrastructure. An observation

made by Lord Buckmaster in *Glenboig Union Fireclay Co Ltd v Commissioners of Inland Revenue* 1922 SC (HL) 112; 12 TC 427, at 464, is exactly apposite:

[T]here is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test.

His Lordship was referring to the revenue law consequence of a test for compensation in respect of a compulsory acquisition of an asset.

43 For these reasons also, I would allow each appeal in relation to the s 21A issue. I add that, since preparing these reasons for judgment, I have had the privilege of reading in draft the reasons for judgment of Thawley J. With these, too, I respectfully agree.

44 The orders made in the original jurisdiction should, to the extent indicated, be set aside. In lieu thereof, it should in each appeal be ordered that each appeal against the objection decision be allowed in part and the matter remitted to the Commissioner for amendment of assessments on the footing that the arm's length value of the infrastructure assets transferred for the purposes of s 21A(2) of the ITAA1936 was the amount of the Rebate paid by VPN (each distributor) to the customer.

I certify that the preceding forty-four (44) numbered paragraphs are a true copy of the Reasons for Judgment of the Honourable Justice Logan.

Associate:

Dated: 21 October 2020

REASONS FOR JUDGMENT

COLVIN J:

- 45 Powercor Australia Pty Ltd (**Powercor**) and CitiPower Pty Ltd (**CitiPower**) are each in the business of providing electricity distribution services in Victoria. Access to a distribution service is needed in order to obtain an electricity supply. Powercor and CitiPower are monopoly suppliers and they each conduct their businesses under the terms of a statutory licence. The amounts they may charge for distribution services and for new connections are regulated.
- 46 Both Powercor and CitiPower are subsidiary members of a consolidated tax group that accounts for its affairs on a calendar basis. Victoria Power Networks Pty Ltd (**VPN**) was the head company of the group. VPN objected to assessments to income tax for the years ended 31 December 2007 to 2010 insofar as the assessments related to the businesses conducted by Powercor and CitiPower. The objections were disallowed and VPN brought appeals that were heard by the primary judge: *Victoria Power Networks Pty Ltd v Commissioner of Taxation* [2019] FCA 77. The primary judge found for the Commissioner. VPN now appeals against the decisions of the primary judge in respect of each of the objections.
- 47 On appeal, the parties are joined as to issues concerning the proper treatment for income tax purposes of dealings relating to certain new connections that were given the somewhat misleading description 'uneconomic connections'. The term was used to refer to instances where it was not profitable to provide distribution services to a customer at regulated prices due to the extent of the costs that would be incurred in connecting the customer's premises to Powercor's or CitiPower's distribution network. However, in such cases, the relevant regulation allowed the distributor to charge a customer for connection services in a manner that was calculated to ensure that the connection was not uneconomic.
- 48 The detailed factual findings of the primary judge are not in dispute and these reasons assume familiarity with those findings. VPN relies upon certain additional aspects of the regulatory regime that are not in dispute. They are addressed in these reasons.

The overall nature of the applicable regulation

49 Relevantly for present purposes, the applicable regulatory regime has the following attributes:

- (1) Distributors are required to offer terms of connection and supply of electricity distribution services to any customer who wishes to be connected to the distributor's network.
- (2) The prices that can be charged by distributors for the ongoing supply of distribution services are capped.
- (3) In cases where connection is sought by a customer, but the net present value of the estimated future incremental cost from the connection (**incremental cost**) exceeds the net present value of the estimated future incremental revenues (**incremental revenues**), the distributor is permitted to charge the customer an amount up to the difference between the two figures (**shortfall**) as a condition of making the connection.
- (4) Where connection is sought by a customer, the distributor is required to make an offer to connect the customer that specifies the amount of any shortfall.
- (5) Distributors are required to provide the option of arranging for a party other than the distributor to provide any connection works, but only to the extent that they could be safely undertaken by parties other than the distributor (known as **contestable works**).

50 In the context of the regulatory requirements, where a customer sought the supply of distribution services and it was estimated that there would be a shortfall, the customer of Powercor or CitiPower, as the case may be, was given two options.

51 Under the first option, the customer was required to make a cash payment to the distributor in the amount of the shortfall (**Option 1**). Although the regulation provides for the full amount of the shortfall to operate as a cap on the amount that could be charged, it was the usual practice for the full amount to be specified under Option 1. If Option 1 was chosen then the new works were undertaken by the distributor and therefore formed part of its network.

52 Under the second option, the customer arranged for third parties to undertake, at the customer's cost, some or all of the contestable works required for the connection and was paid a rebate in a specified amount (**Option 2**). The amount of the rebate was determined by taking the estimate of the relevant contestable works used by the distributor as part of the inputs to calculate the shortfall and then deducting from that amount the shortfall. Once again, although the shortfall operated as a cap on what the distributor could charge for connection services, it

was the practice for the distributor to determine the rebate by reference to the full amount of the shortfall. Under Option 2, it was a condition of the arrangement that the customer was bound to transfer property in the contestable works to the distributor upon the satisfactory completion of the works and 'tie-in' to the distributor's network.

53 Therefore, under Option 1, the customer paid the amount of the shortfall by making a cash payment to the distributor (referred to by the primary judge as the Customer Cash Contribution) and the distributor paid for all the works, including the contestable works. Under Option 2, the customer paid for the cost of the relevant contestable works, transferred the property in those works to the distributor on 'tie-in' and then received the rebate. By reason of the way the rebate was calculated under Option 2, the effect of the arrangement was that the customer was required to bear the shortfall amount (referred to by the primary judge as the Customer Contribution). The rebate was calculated in a way that meant that the customer was not rebated for the amount of the shortfall. Therefore, under both options the customer was required to bear the cost of the shortfall.

54 From the perspective of the distributor, there is no economic difference between Option 1 and Option 2. In both instances the customer must meet the shortfall. The consequence is that the distributor is indifferent as to whether it undertakes all the work or whether the customer arranges to undertake some or all of the contestable work. This appears to have been intended. However, for the customer there are two significant differences between the two options.

55 First, under Option 1, the customer simply pays a cash contribution equal to the shortfall whereas under Option 2, the cost to the customer depends upon the actual costs incurred in undertaking the contestable works. If the customer undertakes those works for less than the estimate of the contestable costs used by the distributor to calculate the shortfall then the burden on the customer is, in fact, less than the shortfall. The cost saving means that the net burden to the customer is the shortfall less the amount of the cost saving. The obverse would apply if there was a cost overrun. Therefore, under Option 2 the overall economic burden on the customer can be less or more than under Option 1.

56 Second, under Option 1 the contestable works are always the property of the distributor whereas under Option 2 the contestable works are undertaken by the customer and property in those works passes to the distributor upon tie-in when the customer is then paid the rebate. So, the customer takes on the risks of cost and delay associated with the construction of the

contestable works. They have to be completed in a satisfactory manner before there can be tie-in.

57 Whether and, if so how, those two differences affected the income taxation treatment in each case was at the heart of the issues in the appeal.

58 Finally, it is to be noted that in many cases there was no shortfall associated with the connection of a customer because the incremental revenue exceeded the incremental cost. In those instances, the customer is still entitled to undertake any contestable works required to make the connection and receive a rebate being the whole of the estimated cost of carrying out the works as determined by the distributor. If the customer can better the distributor's estimate then it will secure a financial advantage to that extent. Otherwise, there is no charge for the connection because such a charge can only be made where there is a shortfall (that is to say where incremental cost exceeds incremental revenue).

The regulation concerning the calculation of the shortfall

59 The amount of the shortfall (being the cap on what the distributor could charge for connection) must be calculated in accordance with the terms of the *Electricity Industry Guideline No. 14 'Provision of services by electricity distributors'* (**Guideline**). Distributors are required to comply with the Guideline as a condition of their statutory licence to operate.

60 The Guideline provides that a customer is not to contribute to the cost of new works or augmentation unless the 'incremental cost' is greater than the 'incremental revenue' as those terms are defined in the Guideline. The incremental cost is an estimate of the overall cost that the distributor expects to incur in undertaking the works to make the connection, such cost to be expressed in net present value terms. It includes (but is not confined to) an estimate of the cost of constructing the connection to the extent that the works might be said to be solely for the benefit of the particular customer. It also includes other costs such as an appropriate share of any cost required to reinforce and maintain the integrity of the network and estimated incremental operating, maintenance and other costs the distributor will incur in providing the connection services over time. The incremental revenue is an estimate of the net present value of the future stream of revenue expected to be earned from making the connection to the premises. Its assessment requires a judgment to be made as to the likely future electricity use profile for the premises. As has been noted, in cases where the incremental cost exceeds the incremental revenue the Guideline requires an offer to be made to supply on the basis that the customer pays the shortfall.

61 Under the terms of the Guideline, the shortfall is required to be determined on the basis, amongst other things, of estimates of the net present value of future costs and revenues for 15 years for business customers and 30 years for residential customers. For a number of reasons, it is unlikely that the differential between incremental cost and incremental revenue will reflect the extent of the shortfall actually incurred over those periods. To the extent that the actual consumption at the connected premises is greater or less than the estimate then more or less revenue could be earned by the distributor. To the extent that efficiencies are achieved in ongoing repair and maintenance costs for the contestable works more profit can be made. Therefore, if the 'uneconomic connection' is made then the existence of the assets that form part of the connection will have an ongoing effect on the income of the distributor. Further, and significantly, the regulated price for the supply of distribution services is set in a manner that means that assets acquired by a distributor are brought to account in setting future prices. Therefore, after the calculation of the shortfall, future revenues would be likely to be greater than the incremental revenue as forecasted because the regulated price would be increased to reflect the additional investment required to make the connection. The extent to which the connection costs actually affect the calculation of the regulated price for distribution services is considered in more detail below.

62 The Guideline refers to the requirement under the distribution licences that distributors must offer connection services where a customer requests a connection to the network so as to allow the supply of electricity from the network. It also refers to the requirement in the distribution licences that distributors 'include in any such offer a price and other terms and conditions which are fair and reasonable and consistent with, amongst other things, any relevant guideline': cl 3.1.5. The Guideline then states that in making a distribution offer, a distributor 'must include a price that has been determined on the basis that ... the amount of any ... customer capital contribution is not to be greater than the amount of the excess of the incremental cost in relation to the connection offer over the incremental revenue': cl 3.2. It then provides a formula to be used by a distributor for 'determining the price to include in its connection offer': cl 3.3.1.

63 Therefore, the Guideline contemplates that where a customer seeks distribution services that require a connection, the distributor will make an offer for the supply of 'connection services' *at a price* that does not exceed the excess of incremental cost over incremental revenue. It is the customer's requirement for distribution services that triggers the prospect of a price being

charged for connection services. Otherwise, the regulated price charged for distribution services will include the connection services.

64 The Guideline goes on to deal with the circumstances in which there must be a tender process for contestable works for new works and augmentation. Significantly, the Guideline does not specify the manner in which an offer must be made where the customer wishes to arrange to carry out the contestable works. Therefore, the form of Option 2 is not dealt with in the Guideline. Instead, the Guideline contemplates a process by which the distributor must conduct a tender process for the contestable works: cl 4.2.1. That obligation does not arise if the customer agrees with the distributor that no tenders should be called for by the distributor: cl 4.2.3. On the basis of the uncontroverted submissions made for VPN on the appeal, the form of offers made to the customers appear to contemplate that in the case of Option 2 there will be no tender process and instead the customer will arrange the supply of the contestable services and receive a rebate of the kind already explained. That form of arrangement is not the subject of the Guideline and it is not apt to describe it as being required by the Guideline or the regulation more broadly. However, it is a form of arrangement that may be said to be affected by the regulatory restraints on distributors, particularly the cap on what can be charged for connection services and the requirements in relation to contestable works.

Regulation of the price that distributors could charge for distribution services

65 The prices that the distributor can charge for distribution services are set by an independent regulator. Their determination involves the application of a building block model to calculate a total revenue that might be expected to be earned if the distributor had to supply distribution services in a market that was competitive. The total revenue figure is then used to determine a schedule of prices which, when applied to expected demand, is expected to result in the distributor earning total revenue at or about the amount determined by the building block model. Within the building block model, an important component is the regulatory asset base or RAB. A value is applied to the RAB by the regulator. Then, in calculating the total revenue required to cover cost and earn a reasonable return, both an appropriate rate of return on the RAB and an expense for depreciation of the RAB is calculated. Those figures are important components of the building block model. Therefore, the regulated price levels are a function of the size of the RAB.

66 It is common ground that new connection assets are added to the RAB and are therefore reflected in future determinations of the regulated price, but significantly *the amount of the*

shortfall is not included in the RAB. So, in a case where Option 1 applies, then to the extent of the Customer Cash Contribution (being the amount of the shortfall), the expenditure on the works to make the new connection is not included in the RAB even though the whole of the cost is borne by Powercor or CitiPower. In a case where Option 2 applies, only the amount of the rebate is included in the RAB (with the consequence that the shortfall amount is not included in the RAB). So, even though the whole of the contestable works undertaken by the customer are transferred to Powercor or CitiPower on tie-in, it is the amount of the estimate for the contestable component of those works (as made by the distributor) less the amount of the shortfall that is included in the RAB. The consequence is that, to the extent of the shortfall amount, no rate of return or depreciation is included in the future building block analysis to determine future prices that the distributor can charge. Otherwise, the connection costs increase the RAB and will be reflected in an increased cap on the prices that can be charged for distribution services in the future.

67 Therefore, although under both Option 1 and Option 2, the distributor owns the connection works and the distributor needs all of the works in order to supply the customer with distribution services, the way the capped price is calculated means that the distributor could not earn any ongoing revenue referable to the shortfall amount (save perhaps for efficiencies in the costs of maintaining the whole of the connection assets including that component represented by the shortfall amount).

The nature of the business of the distributors

68 The distributors are not in the business of supplying connections. Their business involves the supply of distribution services by means of their monopoly networks. The revenue they earn is from supplying distribution services. One way of expanding their businesses is to supply new premises to which there will be the ongoing supply of services. However, they cannot expand their businesses in that way without new connections. In an unregulated market, a distributor might build in the cost of connection to an agreed price and term for an agreement to provide distribution services. Indeed, that is how customers were charged where there was no shortfall. But the regulation capped the price for distribution services. Therefore, in cases where there was an expected shortfall for the connection, unless the customer was required to bear the shortfall the supplier could not afford to pay for the connection because the price that the supplier could charge for its services was capped.

69 Therefore, connection is properly viewed as an integral part of the business activity of the distributor because, without making the connection, there can be no supply of distribution services.

70 Many connections were made both in circumstances where there was a shortfall and in circumstances where there was no shortfall. As the unchallenged findings of the primary judge show, a large number of employees were engaged to make the estimates required in order to determine the amount of the shortfall (and therefore the extent of the contribution required from a customer in any particular case).

71 The arrangements whereby the customer was required to bear part of the connection cost were made to enable the supplier to provide the distribution services on an ongoing basis for the capped price (as reviewed from time to time to bring to account the cost of connections less the shortfall). Significantly, supply of distribution services to such customers was not a revenue neutral proposition. That was because, as has been explained, the component of the incremental cost that related to connection costs (other than the shortfall) was included in the RAB and was used to calculate the regulated price going forward. Therefore, there was no sense in which the transaction with the customer was not economic for the supplier. That would only be the case if the shortfall was not covered.

72 By offering Option 1 or Option 2 to customers where there was a shortfall, the distributors were engaging in their business of supplying distribution services. It was a transaction by which the supplier sought to secure the business of the customer and earned the ongoing revenue to be obtained from supplying distribution services.

73 In that particular context, in practical business terms any amount that the customer paid towards the cost of the connection under Option 1 or any part of the connection cost that was borne by the customer under Option 2 formed part of the price paid by the customer in order to be supplied with the distribution services. From a regulatory point of view, the capped price ensured that customers who did not require a costly connection did not have to subsidise those who did. In both Option 1 and Option 2, the connection assets ended up as the property of the supplier that could be used to effect profitable supply of its distribution services for many years into the future.

The relevant legal principles concerning Option 1

74 The findings by the primary judge as to the principles to be applied were not challenged. As to whether an amount forms part of the taxpayer's assessable income, his Honour summarised the principles in the following terms at [153]-[157]:

Section 6-5(1) of the [*Income Tax Assessment Act 1997* (Cth)] provides that a taxpayer's assessable income includes income according to ordinary concepts, which is called 'ordinary income'. In *Federal Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199, Mason ACJ, Wilson, Brennan, Deane and Dawson JJ stated (at 209) that it was 'well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income'. Their Honours explained that '[b]ecause a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income'. The word 'gain' is not here used in the sense of the net profits of the business, for the topic under discussion is assessable income, that is, gross income: *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 at 318 per Barwick CJ, Kitto and Taylor JJ.

In *GP International Pipecoaters Pty Ltd v Federal Commissioner of Taxation* (1990) 170 CLR 124 (*GP International Pipecoaters*), the High Court (Brennan, Dawson, Toohey, Gaudron and McHugh JJ) approved (at 136) the statement of Windeyer J in *Scott v Federal Commissioner of Taxation* (1966) 117 CLR 514 at 526 that '[w]hether or not a particular receipt is income depends upon its quality in the hands of the recipient'. In *GP International Pipecoaters*, the High Court went on to quote with approval the statement of Cozens-Hardy MR in *Hudson's Bay Co Ltd v Stevens* (1909) 5 TC 424 at 436 that 'if the money is otherwise liable to income tax it cannot escape taxation by reason of its being applied to a capital purpose'.

The issue in *GP International Pipecoaters* concerned the character of certain establishment costs as receipts in the hands of the taxpayer. The High Court emphasised (at 138) the 'importance of ascertaining the scope of a business and a recipient's purpose in engaging in it as a means of determining the character of a receipt'. The High Court stated (at 141) that, applying a 'business conception to the facts' (see *Federal Commissioner of Taxation v Becker* (1952) 87 CLR 456 at 467), the receipt of the establishment costs must be classified as a receipt of income. The High Court in *GP International Pipecoaters* then stated (at 142):

Next, it is necessary to consider the taxpayer's submission that the cases show that a receipt of moneys intended by payer and payee to recoup a recipient's capital expenditure is a receipt of a capital nature. That proposition can be accepted when the amount is received by way of gift or subsidy to replenish or augment the payee's capital, for in such a case the receipt cannot fairly be said to be a product or incident of the payee's income-producing activity: see *Hayes v Federal Commissioner of Taxation* [(1956) 96 CLR 47, at pp 54-56]; *Federal Coke Co Pty Ltd v Federal Commissioner of Taxation* [(1977) 77 ATC 4,255]; *Reckitt & Colman Pty Ltd v Federal Commissioner of Taxation* [(1974) 23 FLR 58; 3 ALR 381]; *Seaham Harbour Dock Co v Crook (HM Inspector of Taxes)* [(1931) 16 TC 333]. 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.

The High Court then considered two cases relied upon by the taxpayer in which payments made under a contract to recoup capital expenditure were held to be capital in the hands of the recipient - *Boyce (HM Inspector of Taxes) v Whitwick Colliery Co Ltd* (1934) 18 TC 655; [1934] All ER 706 and *APA Fixed Investment Trust Co Ltd v Federal Commissioner of Taxation* (1948) 8 ATD 369; 4 AITR 105. The High Court doubted the correctness of *Boyce* and distinguished *APA*. The High Court concluded (at 145) that the establishment costs were received as part of the taxpayer's assessable income. This was because they 'were not received as the price of a capital asset, nor as a payment dissociated from the taxpayer's business; they were received as part of the remuneration earned by the carrying on of its business which consisted in the performance of the contract, that is, in constructing the plant and coating the pipe required'.

The mere fact that a taxpayer is engaged in a business at the time of receiving a payment and the payment bears some connection to that business will not be sufficient to stamp the receipt with a revenue character: *Federal Commissioner of Taxation v Spedley Securities Ltd* (1988) 88 ATC 4126 at 4130; *Westfield Ltd v Federal Commissioner of Taxation* (1991) 28 FCR 333 at 342; *Federal Commissioner of Taxation v Hyteco Hiring Pty Ltd* (1992) 39 FCR 502; *First Provincial Building Society v Federal Commissioner of Taxation* (1995) 95 ATC 4145.

- 75 If a payment is not assessable according to ordinary concepts, it may still form part of the assessable income of a taxpayer on the basis that it is an assessable recoupment under Subdivision 20-A of the *Income Tax Assessment Act 1997* (Cth). It was common ground that if the Customer Cash Contribution was not income according to ordinary concepts then it was an assessable recoupment to be assessed over time.

The findings of the primary judge as to Option 1

- 76 The primary judge found that the Customer Cash Contributions were derived by the distributors under transactions that occurred as an ordinary incident of their electricity distribution businesses: at [165]. The connection of new customers was a recurrent and regular activity that the distributors were required to carry out as part of their businesses by the conditions of the licences: at [167], [169]. The connections resulted in the production of tariff income (that is, charges for the supply of distribution services): at [167]. The Customer Cash Contributions formed part of the consideration payable to the distributors for new connections under contracts entered into with their customers (that is, customers purchasing distribution services): at [168].

VPN's case on appeal as to Option 1

- 77 In its submissions, VPN emphasised the fact that the Customer Cash Contributions were received under a regime governed by the Guideline. It was claimed that the Guideline required customers to make the Customer Cash Contributions 'as a contribution to the capital cost of new works for connection'. Further, it was said that the Guideline did not allow the distributors

to earn any profit on the connection. The most they could charge was an amount to recover the shortfall. In addition the regulatory scheme for setting the prices that could be charged for distribution services did not bring to account the Customer Cash Contributions and so the distributors could not earn a regulated rate of return on those amounts.

78 Reliance was placed by VPN upon the reasoning in *G.P. International Pipecoaters Pty Ltd v Federal Commissioner of Taxation* [1990] HCA 25; (1990) 170 CLR 124 (*G.P. International Pipecoaters*) that the effect that a receipt of monies intended by payer and payee to recoup a recipient's capital expenditure is a receipt of a capital nature 'when the amount is received by way of gift or subsidy to replenish or augment the payee's capital, for in such a case the receipt cannot fairly be said to be a product or incident of the payee's income producing activity': at 142. However, the High Court went on to say:

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.

79 Since the decision in *G.P. International Pipecoaters*, Subdivision 20-A of the *Income Tax Assessment Act 1997* has been enacted. Under those provisions a recoupment is assessable over time rather than in the year of receipt. VPN sought to characterise the Customer Cash Contributions as reimbursement and not remuneration. They were said to be a recoupment of a portion of the outgoings to be incurred in constructing the connection works. On that basis they were said by VPN to be an assessable recoupment.

Findings of primary judge as to Option 1 not demonstrated to be in error

80 The difficulty with the case advanced by VPN is that it segregates the arrangements for the connection from the earnings available from the supply of distribution services once a customer was connected. The business of each of Powercor and CitiPower involved supplying distribution services to those customers connected to its network. Where the supply of those services at the capped price meant that there was no shortfall then no charge would be made for connection. In those instances any cost associated with arranging the connection and cost of ongoing repair and maintenance of the relevant assets were costs of the business incurred in earning the revenue from supplying distribution services. The fact that the Customer Cash

Contributions were made in cases where the regulated price did not cover all the costs of the connection did not alter the nature of the dealings between the distributors and their customers.

81 Further, the amount of the Customer Cash Contribution was not calculated as a recoupment of capital. 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 over cost in supplying distribution services to the customer at the prevailing capped price for distribution services. The requirement that the deficiency be covered by a payment to be made by the customer was simply a means of ensuring that the price paid by the customer (and subsequent users of electricity at the relevant premises) for the connection and the distribution services was profitable.

82 Once the nature and scope of the business of the distributors are brought to account and the nature of the shortfall calculation is understood, it is evident that the Customer Cash Contribution is part of the price paid to the distributors for services provided in the ordinary course of their business. The payment is no more a reimbursement or recoupment than the component of the price paid by customers when incremental revenue exceeds incremental cost (and there is no need for a further charge for connection).

83 The primary judge was plainly correct, for the reasons his Honour gave, to conclude that the Customer Cash Contributions received by the supplier under Option 1 were ordinary income.

The Commissioner's case as to Option 2

84 As to Option 2, the Commissioner claimed before the primary judge that the transaction involved the customer making a payment to Powercor or CitiPower in the amount of the shortfall. The Commissioner's position compared the case where there was a shortfall with the case where incremental revenue exceeded incremental cost and there was no shortfall. In a case where the customer undertook contestable works and there was no shortfall then the customer was reimbursed the full amount of the distributor's estimate of the costs of construction. In that context, the Commissioner claimed that under Option 2, the actual consideration paid by the customer for the connection services was the shortfall which was met by being brought to account in determining the amount of the rebate. It was said that the rebate would otherwise be for the full amount of the estimated costs of the contestable works

undertaken by the customer. In those cases where there was a shortfall, the Commissioner sought to characterise the rebate as a balancing item as between the cost of the contestable works being undertaken by the customer (on the one hand) and the shortfall (on the other hand).

85 The Commissioner's position was that there was no distinction to be drawn between Option 1 and Option 2 because in both instances the transaction provided for the customer to provide consideration to Powercor or CitiPower in the amount of the shortfall.

86 On that basis, the Commissioner then claimed that Option 2 resulted in the receipt by the distributors of income according to ordinary concepts in the amount of the shortfall (described by the primary judge as the Customer Contribution). That claim was not accepted by the primary judge. In the appeal, the Commissioner maintained that claim by way of notice of contention.

87 In the alternative, if assets transferred under Option 2 were found to be a non-cash benefit then the Commissioner contended that their arm's length value was the full amount of the estimated cost of constructing the contestable assets that the customer had elected to undertake. The amount of the rebate was to be deducted from that amount as a 'recipient's contribution' with the result that Powercor or CitiPower as the case may be received assets to the value of the shortfall which was to be treated as a non-cash business benefit.

Relevant legal principles as to Option 2

88 The principles as to income according to ordinary concepts have been set out above. If Option 2 did not result in the receipt by VPN of ordinary income in the amount of the shortfall then it was accepted that there had been non-cash benefits received by Powercor or CitiPower under dealings where Option 2 had been chosen. In that event, the only issue between the parties concerned the amount of that non-cash benefit. As to non-cash benefits, relevantly for present purposes, s 21A of the *Income Tax Assessment Act 1936* (Cth) provides:

21A Non-cash business benefits

- (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.

...

- (5) In this section:

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; or
- (b) if such an amount cannot be practically determined - such amount as the Commissioner considers reasonable.

The findings of the primary judge as to Option 2

89 As to the claim that the Option 2 transactions resulted in Powercor and CitiPower receiving income according to ordinary concepts, the primary judge found that there were significant distinctions between the Option 1 and the Option 2 transactions. In particular, under Option 2 there was no obligation as such to pay the shortfall. The primary judge summarised the position in the following way at [179]:

There was no obligation as such on the customer to pay the Customer Contribution to the Distributor (even assuming that [the Guideline] applied to an Option 2 situation). Rather, the Distributor was entitled to charge a price determined on the basis that the customer was not to contribute to the capital cost of the works unless the incremental cost was greater than the incremental revenue, and the amount of any such customer contribution was not to be greater than the incremental cost less the incremental revenue. In practice, ... the Distributor offered to pay the customer an amount (the Rebate) calculated as the estimated cost of construction less the Customer Contribution. The customer accepted that offer. In these circumstances, in my view, the Customer Contribution was not a payment or gain received by the Distributor; it was merely a component used in the calculation of the amount to be paid by the Distributor to the customer. I accept that a settlement of accounts by which items on one side are agreed to be set off against items on the other side may amount to payment of the sums stated in the account: see *JC Williamson's Tivoli Vaudeville Pty Ltd v Federal Commissioner of Taxation* (1929) 42 CLR 452 at 478. But that is not the case here ... The customer was not under an obligation to pay the Customer Contribution. It was merely a component in the calculation of the Rebate. Accordingly, in my view, the Customer Contribution was not income according to ordinary concepts.

90 The primary judge then went on to find that the assets that were transferred under Option 2 constituted a non-cash business benefit for the purposes of s 21A: at [182]. It was common ground that the assets were received on revenue account: at [173]. His Honour concluded that the arm's length value could be determined by reference to the factual findings concerning the nature of the transaction that occurred under Option 2 and it was not necessary to refer to the

expert valuation evidence that had been led by the parties: at [188]. Before an agreement was made to give effect to Option 2, Powercor or CitiPower had calculated the cost to undertake the contestable works. The amount of the shortfall had been identified. The estimated cost of construction was calculated in the same way whether the works were to be carried out by the distributor or the customer: at [189]. Therefore, on the reasoning of the primary judge, as a matter of substance, the amount attributed to the transferred assets by the distributor and implicitly by the customer was the estimated cost of construction: at [190]. The adjustment to that figure was made as part of the application of the regulatory regime and the arm's length value for the purposes of s 21A(5) was the estimated cost of construction: at [192].

VPN's case on appeal as to Option 2

91 VPN's position on appeal was that the transaction by which Option 2 was carried into effect did not involve any agreement by the customer to pay the shortfall to Powercor or CitiPower. Rather, it was a transaction by which the contestable works for the connection were arranged by the customer at its cost on the basis that it would receive the rebate (which was expected to be only a partial reimbursement for the works). Further, although the nature of the transaction required the customer to transfer the property in the works to Powercor or CitiPower and it was not a transfer by way of gift, the value of the transferred assets in the hands of Powercor or CitiPower was limited by the extent to which it could generate value for the distributor. By reason of the form of regulation and the way in which the RAB was used to determine the price that the distributor could charge for distribution services, the amount of the rebate represented the value of transferred assets to the distributor. In short, the component of the cost of the transferred assets that represented the shortfall was of no value to the distributor because it was not entitled to any return on the component of the cost of the contestable works that was not paid for as part of the rebate.

92 On the above basis, VPN claimed that the non-cash business benefit that it derived in the form of the transferred assets as part of Option 2 was the amount of the rebate.

Under Option 2 the shortfall amount is not income according to ordinary concepts

93 The primary judge was correct for the reasons his Honour gave to reject the Commissioner's claim that the Option 2 transactions resulted in Powercor and CitiPower earning income according to ordinary concepts. The Commissioner's case failed to give due regard to the character of the Option 2 transaction. It did not involve any commitment by the customer to make any payment to the distributor in the amount of the shortfall. Rather, it involved the

customer undertaking the contestable works. The evident purpose of doing so was to afford the customer the opportunity to undertake those works at a lower cost than the estimate and, from the perspective of the customer, thereby reduce the extent of the consideration it had to pay for the connection. In order for the transaction to have that character there could be no obligation on the part of the customer to pay the distributor the amount of the shortfall. The payment of the rebate was not a balancing figure. The obligation of the distributor was to pay the rebate, not to pay the full estimated cost of the contestable works. The obligation of the customer was to undertake the contestable works and then transfer property in those works at tie-in not to pay the shortfall as well as undertake the works.

Under Option 2 the value of the non-cash business benefit to the distributors was the amount of the rebate

94 As Option 2 did not result in ordinary income for the distributors, the remaining issue concerns the amount of any non-cash business benefit to Powercor and CitiPower under Option 2. The case was argued on the basis that the relevant non-cash business benefit took the form of the assets that were transferred by the customer to the distributor under Option 2. Therefore, the point turns on the arm's length value of those assets. However, it is the arm's length value in a world where the taxpayer and the provider of the benefit have earned the income in the manner in which the events have occurred. The fact that some other transaction or dealing may have been entered into between the taxpayer and the provider of the benefit in which the non-cash benefit may have had a different value is not to the point. Section 21A defines the amount of income to be attributed to the benefit having regard to the manner in which it was earned.

95 It is not contended by the Commissioner that the amount of the non-cash business benefit cannot be practically determined. Therefore, it is paragraph (a) of s 21A(5) that is applicable. Section 21A(2)(a) has two components: (a) the arm's length value; and (b) the recipient's contribution (if any). Where the recipient of the non-cash benefit (in this case the distributor) makes a contribution to the non-cash benefit then the provision contemplates that there will be a calculation that brings the contribution into account.

96 The first component (arm's length value) focusses on 'the amount that the recipient (in this case the distributor) could reasonably be expected to have been required to pay to obtain the benefit from the provider (in this case the customer)' dealing at arm's length. It posits a transaction in which the particular parties concerned are dealing with each other at arm's length and by which

the recipient of the benefit (the distributor) is paying to obtain the benefit from the provider (the customer).

97 The language used in paragraph (a) of s 21A(5) reflects an assumption that it will be possible to identify a particular and singular value that could reasonably be expected to have been required to be paid by the recipient to the provider for the benefit in the events which have occurred.

98 In the present case, issues arise as the manner of application of paragraph (a) within the regulated environment in which the parties entered into the transaction for the transfer of the assets. As has been explained, Powercor and CitiPower were constrained as to the price they could charge for distribution services. The consequence was that in the case of the so-called uneconomic connections, there needed to be a regulatory mechanism by which the shortfall would be borne by the customer. It could not be built into the price for distribution services being the means by which the distributor would ordinarily earn income to cover its costs. Therefore, the regulation required that the customer could not secure distribution services in the case of uneconomic connections unless the customer bore the shortfall. In that regard it is to be noted that the shortfall was not simply a component or part of the costs of the connection assets. Rather, its quantum was a function of a calculation that brought to account an estimate of those costs but also projections as to other costs such as operating and maintenance costs and the expected utilisation of the distribution network in order to supply electricity to the premises to be connected.

99 Nevertheless, the regulated environment assured the distributor that it would not have to bear the shortfall whatever form the transaction with a customer might take. The distributor could not be made to enter into a transaction of a kind where the shortfall was not borne by the customer. Equally, where the shortfall was met by the customer the distributor was bound to connect the customer and provide distribution services. It was in that context that the amount that the distributor could reasonably be expected to have been required to pay to obtain the benefit of the assets provided by the customer under Option 2 was to be determined.

100 As the primary judge correctly found, the assessment of that amount must have due regard to the regulatory regime that provides the business context in which the arrangement is made for the supply of connection services and a valuation approach which ignores that context is of no assistance: at [176], [210]. Further, it is the perspective of the recipient of the benefit not the outcome of some notional willing buyer and willing seller analysis that is relevant: at [176].

101 As the primary judge found at [190], there were two important aspects to the regulation when it came to considering the amount that the distributor could reasonably have been required to pay to obtain the benefit of the transferred assets, namely:

First, [the Guideline] provided that the Distributor was entitled to charge a price determined on the basis that the customer was not to contribute to the capital cost of the works unless the incremental cost was greater than the incremental revenue, and the amount of any such customer contribution was not to be greater than the incremental cost less the incremental revenue. Secondly, the RAB was calculated in a way that ensured that the pricing going forward was not affected by the capital expenditure relating to the new connection so far as it was covered by the customer contribution.

102 In any case, no matter the economics, the distributor needed to add the relevant assets to the network in order to make the connection. It could not connect the customer without securing the benefit of all the required connection assets. Therefore, all those works had to be undertaken if the customer was to be supplied with distribution services. The cost of doing so had to be incurred.

103 However, within the regulated environment in which the distributors operated, the distributor could not be forced to undertake the connection unless the customer bore the shortfall. Further, there was no means by which the distributor could increase its price for distribution services so that it could cover the shortfall out of its own earnings. It was that context that determined the value of the connection assets to the distributor.

104 The issue as to Option 2 on which the present case turns is whether the form of transaction means that Powercor and CitiPower, in that instance, are only willing to pay a lesser amount for the transferred assets, being the net amount of the difference between the estimated cost of the assets to be provided by the customer and the shortfall. Significantly, Option 2 is not required by the regulatory scheme. What is required is that the customer be connected and that an option be given for other parties to tender for the supply of the contestable assets needed to make the connection. What is also required is that the customer meet the shortfall.

105 If there was an independent regulatory obligation by which the customer was required to provide the distributor with the shortfall then it might be said that the distributor could reasonably be expected to have been required to pay the full amount for the contestable assets comfortable in the knowledge that the terms of the regulation would require the customer to pay the shortfall. However, the regulation did not impose such an obligation. Rather, it required the distributor to enter into an agreement with the customer but only if the customer bore the

burden of the shortfall. In a commercial environment that was regulated in that manner, the amount that the distributor could reasonably have been expected to pay under the transaction whereby it received the non-cash business benefit of a transfer of the relevant contestable assets was the estimated cost of connection less the shortfall (being the amount of the rebate). In effect, the customer valued the connection assets at their full cost but the distributor valued them at the amount of the rebate.

106 It follows that the arm's length value under Option 2 is the estimated cost of the contestable assets less the shortfall. Then under s 21A(2)(a) the arm's length value is to be reduced by the recipient's contribution if any. In the case of Option 2, the recipient's contribution (that is, the distributor's contribution) is the amount of the rebate. The consequence is that the non-cash business benefit to each of Powercor and CitiPower under Option 2 was nil.

107 It follows that, with due respect, the appeal in respect of the primary judge's conclusion as to the effect upon the assessable income of VPN of a transaction in the form of Option 2 should be upheld.

Conclusion

108 For the above reasons, the appeals should be dismissed as to Option 1 and allowed as to Option 2. There should be provision for short written submissions as to costs.

I certify that the preceding sixty-four (64) numbered paragraphs are a true copy of the Reasons for Judgment of the Honourable Justice Colvin.

Associate:

Dated: 21 October 2020

REASONS FOR JUDGMENT

THAWLEY J:

109 I have had the advantage of reading the reasons of Logan J and Colvin J. I agree that the appeal should be allowed on the basis and for the reasons identified by their Honours.

110 Powercor and CitiPower, two subsidiaries in the VPN consolidated group, referred to for convenience as “VPN”, carried on business distributing electricity in Victoria. Each subsidiary held a distribution licence under the *Electricity Industry Act 2000* (Vic). The consequences of the statutory regime included:

- (1) First, VPN had to connect a “customer” to the electricity network even where the “incremental cost” of the connection exceeded the “incremental revenue” anticipated from the connection. Although the label might be inaccurate in some respects, these connections are conveniently labelled “uneconomic” from the perspective of VPN. The amount by which the anticipated cost of construction exceeded the anticipated revenue is referred to as the “shortfall”.
- (2) Secondly, although VPN had no choice but to connect the customer, the customer wanting an uneconomic connection had to bear the shortfall whether or not VPN (Option 1) or the customer (Option 2) undertook the relevant “contestable works” required for the connection.

111 Regulations set the maximum price distributors could charge. This was determined having regard to the “regulatory asset base” (**RAB**) which reflected the capital costs taken to have been incurred by the distributor but not recovered. The regulated price was intended to provide the distributor a return on its capital costs as recorded in the RAB and a return of those capital costs. The shortfall amounts did not form a part of the RAB, reflecting the fact that VPN did not bear the capital cost of connections to the extent necessary to ensure the connection was economic; the customer bore the cost of construction to the extent the costs made the connection “uneconomic”. One reason the shortfall did not form a part of the RAB was to ensure that existing customers did not bear the cost of uneconomic connections. Because the shortfall was excluded from the RAB, the regulated price was not increased by inclusion of the shortfall in the RAB, and existing customers did not subsidise uneconomic connections through increased prices.

112 There were two issues in the proceedings:

- (1) The first issue concerned Option 1: whether the customer cash contributions under Option 1 were ordinary income of VPN;
- (2) The second issue, involving two questions, concerned Option 2:
 - (a) whether the shortfall borne by the customer represented ordinary income of VPN; and
 - (b) if not, the arm's length value of the assets (the "contestable works") transferred by a customer to VPN.

Option 1

113 If a customer wanted an uneconomic connection and chose Option 1:

- (1) VPN paid the full amount of the construction costs;
- (2) the customer paid to VPN a "customer cash contribution" representing the shortfall; and
- (3) VPN always owned the assets.

114 The customer cash contribution was ordinary income of VPN because it was received in the ordinary course of VPN's business, a part of which was connecting customers to the network in accordance with the applicable regulatory regime. Whilst the sale of electricity to customers was by a retailer rather than the distributor, the distributor dealt with customers in relation to connections. The character of the receipt is not determined by the fact that the parties might be seen to have intended that the customer cash contributions be applied to recoup capital expenditure or to have been calculated, justified or required on that basis. The receipt of the customer cash contributions was in the ordinary course of VPN's business because the performance of the contracts to which those payments related and which gave rise to those receipts was a part of VPN's business; the amounts were not "received by way of gift or subsidy to replenish or augment the payee's capital" and nor were they payments by way of reparation: *G.P. International Pipecoaters Pty Ltd v Federal Commissioner of Taxation* (1990) 170 CLR 124 at 142.

Option 2

115 If a customer wanted an uneconomic connection and chose Option 2:

- (1) the customer paid for the works;

- (2) VPN paid the customer a “rebate” such that the customer only ultimately bore the shortfall (economically equivalent to the customer’s position under Option 1); and
- (3) the assets were transferred by the customer to VPN.

116 The first question is whether the shortfall borne by the customer represented ordinary income of VPN. It did not. The customer bore the shortfall, but there was no obligation on a customer to pay the shortfall to VPN. The shortfall did not represent or constitute a gain made by VPN.

117 The second question is the arm’s length value of the assets paid for by the customer and transferred to VPN. Those assets were a “non-cash business benefit” derived by VPN. Section 21A of the *Income Tax Assessment Act 1936* (Cth) includes:

21A Non-cash business benefits

- (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.

118 Subsection (5) of s 21A defines “arm’s length value”:

- (5) In this section:

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; or
- (b) if such an amount cannot be practically determined—such amount as the Commissioner considers reasonable.

119 Section 21A requires that the value of a “non-cash business benefit” be determined on the basis of what could reasonably be expected had the parties been dealing with each other at arm’s length. The evident object of the provision is to ensure that the value of an identified non-cash business benefit is determined objectively on the basis of an arm’s length dealing: what “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".

120 If parties were not dealing with each other at arm's length, what "the recipient could reasonably be expected to have been required to pay" is determined without regard to those matters which relevantly affected the actual transaction but which would not have been found if "the transaction" had been "a transaction" between parties dealing at arm's length.

121 VPN and its customers were dealing with each other at arm's length. The parties' actual dealing reflected that which could reasonably be expected between parties dealing at arm's length in the market in which the relevant transaction took place. The parties' dealing evidenced what "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".

122 This was not a case in which it was necessary, in order to determine the "arm's length value", to hypothesise a transaction, different from the actual transaction, in which parties not dealing at arm's length were assumed to be dealing at arm's length. If it had been necessary to hypothesise "a transaction" which differed from "the transaction", the latter being a transaction which was in fact the product of an arm's length dealing, it would have been necessary to identify the different terms of that hypothesised transaction and why the departure from the arm's length transaction was appropriate and permitted by the terms of the statute.

123 What VPN "could reasonably be expected to have been required to pay" for the transferred assets in a transaction between parties at arm's length, in the regulated market in which VPN and the customer were required to transact, was the amount of the rebate, as VPN in fact paid. VPN 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) VPN was only required to pay to the customer an amount representing a portion of the construction costs. VPN could only ever have been expected to pay the rebate to obtain the benefit in an arm's length transaction.

124 One of the features of the regime was that distributors were not to bear the cost of uneconomic connections. If a customer wanted an uneconomic connection, the customer would bear the

shortfall. The question is the value of the transferred assets not the cost of construction, but it is as well to point out that the distributor would never bear the whole cost of construction in uneconomic Option 2 cases. It would bear, through the rebate, that part of the cost of construction which made economic sense: the cost of construction less anticipated revenue.

125 The rebate also reflected the economic value to VPN of the transferred assets. The rebate was an amount calculated to ensure that VPN was not required to pay more for the transferred assets than it was expected to obtain in revenue and to ensure that the customer bore the construction costs to the extent the connection was uneconomic. The economic value of the assets to VPN under Option 1 was no different: VPN paid the full construction costs, but only because the customer wanting the uneconomic connection could require VPN to make what was from VPN's perspective an uneconomic connection and was prepared to pay to VPN the "shortfall", namely that part of the cost of construction which was uneconomic for VPN.

126 If the whole cost of construction were the arm's length value to VPN of the transferred assets, then VPN would be assessed on an amount which it did not receive and would never receive. It would also be entitled to deductions for capital allowances based on costs which it never incurred or bore.

I certify that the preceding eighteen (18) numbered paragraphs are a true copy of the Reasons for Judgment of the Honourable Justice Thawley.

Associate:

Dated: 21 October 2020