Australian Tax Law
Bulletin

Characterising expenditure as revenue or capital — is the distinction becoming clearer?

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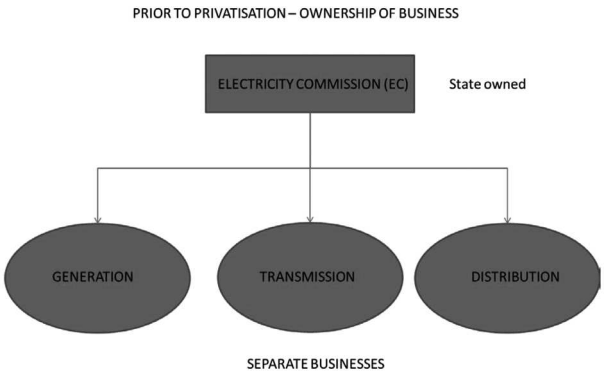
The recent High Court decision in *AusNet Transmission Group Pty Ltd v FCT*[1] which was an appeal from the Full Federal Court decision known as *SPI PowerNet Pty Ltd v FCT*[2] has again confirmed the general principles concerning the distinction between characterising an expense as revenue or capital. The real issue though appears to relate to how to apply such well known principles to modern commercial situations.

Background

The following background to the facts of the case is drawn from the article by Bill Mavropoulos in *ATLB* 2(4).[3] It should also be noted that SPI PowerNet changed its name to AusNet Transmission group.

The Victorian Government, through their Electricity Commission, originally owned the businesses that provide Victorians with electricity. In the 1990s the government decided to privatise part of these businesses. In order to examine relevant outgoings, it is important to gain a broad understanding of the way this privatisation process was conducted.

The first thing to understand is, broadly, who owned the electricity businesses before the privatisation. The Electricity Commission originally owned three related businesses as shown in the diagram below:

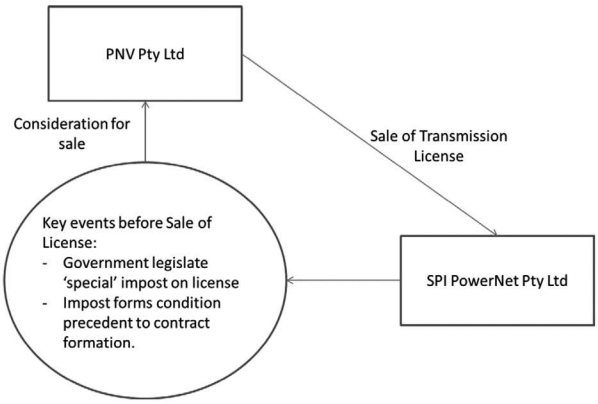


The businesses did three things:

- generated electricity;
- transmitted it to where it is used; and
- distributed it as appropriate.

This issue of deductibility arose with reference to the privatisation of the transmission business. In anticipation of the privatisation, a state owned company (Power Net Victoria Pty Ltd (PNV)) was set up. A licence in respect of the rights to run the transmission business was provided to the state owned company.

The licence asset was then sold to the taxpayer (SPI PowerNet). However, a number of key events occurred prior to the sale of the license to SPI PowerNet. First, an impost was declared on the holder of transmission licences for a finite period of time in Victorian legislation (s 163AA of the Electricity Industry Act 1933 (Vic)). This impost was broadly designed to ensure a privatised transmission business did not earn too much profit from the transmission business in question. Second, this impost became a condition precedent to the contract and warranties were made in respect of this obligation by the parent company of SPI PowerNet before the asset sale agreement could be executed. This can be represented diagrammatically below:



The transmission licence imposts were then the subject of protracted legal argument in relation to whether they were deductible under s 8–1 of the Income Tax Assessment Act 1997 (Cth) (ITAA 97). The Full Federal Court held, by majority, that the imposts in question were capital in nature. The High Court granted special leave to appeal and also ordered that the appellants name be changed to AusNet Transmission Group Pty Ltd for the court's record.

High Court decision — overview

The High Court, by a majority of 4–1, dismissed the appeal. French CJ, Kiefel and Bell JJ delivered a joint judgment holding that the impost imposed on AusNet, as the holder of an electricity transmission licence pursuant to a state legislative framework, should be characterised as capital and hence precluded from deductibility under s 8–1 of the ITAA 97.

The joint judgment only dealt with the question of the characterisation of the payment of the impost as being capital in nature. As the joint judgment held that the payments made were capital in nature (which was the basis of the appeal by AusNet) then there was no need to determine whether the payments satisfied the positive requirement of s 8–1 of the ITAA 97. Only the dissenting judgment of Nettle J dealt with the positive requirements of s 8–1. In [132]–[135] Nettle J dealt with the contention that the payments were not incurred in the gaining or producing of assessable income. His Honour made short work of the contention by the Commissioner that the charges were not incurred in the gaining or producing of assessable income because they were calculated by reference to AusNet's expected profits. It was clear, according to Nettle J, that this line of reasoning should be rejected outright and that it was quite obvious that, as the holder of a licence, AusNet was bound to pay the charges for business purposes.

Although the majority judgments do not deal with the issue of the positive limbs of s 8–1, it seems to be quite evident that the particular requirement had been satisfied. In particular it is evident in the judgment of Gageler J that the underlying rationale for the payment of the charges was in relation to the commercial context within which the specific expenditure was made, including the commercial purposes of the taxpayer in having become subjected to any liability that is discharged by the making of that expenditure.[4]

Capital/revenue distinction

The importance of the High Court decision lies in the discussion concerning the distinction between capital and revenue for s 8–1 purposes. The majority joint judgment made reference to the well-known passages about the characterisation of capital and revenue laid out by Dixon J in *Associated Newspapers Ltd v FCT*[5] (*Associated Newspapers*) and interestingly made reference to the fact that both parties relied on the well-established principles.

Of real interest is the fact that the majority joint judgment then focused on the clarifying comments by Dixon J in *Hallstroms Pty Ltd v FCT*[6] that the distinction depends upon what the expenditure is calculated to effect, from a practical and business point of view.[7] Such an emphasis on the practical and business point of view is reflected in the decisive reasoning by the majority joint judgment. Their Honours stated that:[8]

> AusNet did not pay the charges in order to reimburse the State for excess revenue it might generate as licence holder. From a practical and business point of view, the assumption of the liability to make the expenditure was calculated to effect the acquisition of the transmission licence and the other assets the subject of the Asset Sale Agreement.

Of more interest is the approach by Gageler J on the same point. His Honour made it clear throughout the judgment that the distinction depends upon what the expenditure is calculated to effect from a practical and business point of view.[9] In determining that the payment was of a capital nature, Gageler J stated: "In my view, from a practical and business perspective, the expenditure was expenditure which AusNet was required to make in order to acquire the transmission licence and other assets."[10] Even the dissenting judgment of Nettle J was premised on the practical and business point of view.[11]

For practitioners advising business taxpayers, the High Court judgment has strongly reinforced the practical and business approach and has given clear guidance that this is the appropriate analysis required. This is particularly the situation where there is no clear authority on point, as was the situation in the *AusNet* case. So although each matter is dependent upon the particular facts and circumstances of that case, it is considered that the High Court is signalling a clear approach to be taken for business taxpayers which builds upon the well-known and universally applied principles identified by Dixon J in *Associated Newspapers*.

Characterisation of the expenditure — statutory or contractual obligation

This is a critical aspect of the case. AusNet's proposition was that the total purchase price, which did not include the s 163AA charges, was the amount expended by AusNet to acquire the assets. The licence fees were described as future licence fees, payable by the buyer, pursuant to the contractual obligation of the asset sale agreement.

The majority joint judgment rejected this argument. Instead by entering the asset sale agreement, the taxpayer assumed the statutory liability under s 163AA of the Electricity Industry Act. By agreeing to acquire the transmission licence and the other assets, there was an acceptance of the statutory liability as imposed under the legislation. Gageler J was very clear on this point. His Honour agreed with:[12]

> … the joint reasons for the majority judgment that cl 13.3 (d) [of the asset sale agreement] imposed a contractual obligation on Ausnet to make the expenditure which was independent of the statutory liability imposed on AusNet under s 163AA of the Electricity Act.

The statutory liability was applicable to whoever held the transmission licence and it was "an 'impost' relevantly payable by the holder of the Transmission Licence to the Treasurer in amounts and at times specified in the Order in Council".[13] The holding of a transmission licence was a condition precedent to the completion of the asset sale agreement. As was said by the majority in their joint judgment:[14]

> The promise [in cl 13.3(d) of the asset sale agreement] was consideration moving from AusNet … and was necessary to secure not only the transmission licence but the other assets that were the subject of the sale.

Again "from a practical and business point of view, the assumption of the liability to make the expenditure was calculated to effect the acquisition of the transmission licence and the other assets… The transmission licence was an intangible asset, but was properly viewed as part of the structure of the business. Without it, acquisition of the rest of the assets was pointless".[15]

In short the imposts, whenever they were levied, were a direct consequence of the cost to AusNet of securing acquisition of the transmission licence and other assets. The obligation to pay the imposts was inherently linked to the statutory requirement that, to run an electricity business, there was a need to have a transmission licence. Those imposts were to be payable by the holder of the transmission licence, in amounts and at times specified in the Order in Council and were not a periodic payment referable to the holding of the transmission licence.

Conclusion

The High Court decision has confirmed the principles to be applied in characterising expenditure as either capital or revenue. In particular the practical and business perspective of the expenditure should be emphasised and the commercial context in which the payment has been made. Practitioners would do well to take heed of this approach when advising business clients.

The High Court decision is also important in recognising that a statutory requirement, as a condition precedent to a contractual obligation, can be the cause of the present and existing obligation in respect of the outgoing and that the method concerning the amounts and timing of the imposts, as specified by the legislative framework, does not make the expenditure a recurring revenue payment. This is an important lesson for taxpayers and their advisers.

This paper has been subject to an independent review.

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Footnotes

1. *AusNet Transmission Group Pty Ltd v FCT* (2015) 322 ALR 385; 89 ALJR 707; [2015] HCA 25; BC201507278.
2. *SPI PowerNet Pty Ltd v FCT* (2014) 220 FCR 355; [2014] FCAFC 36; BC201402371.
3. Bill Mavropoulos "The convenient fiction — deductibility and capital" (2015) 2(4) *ATLB* 67.
4. Above n 1, at [74].
5. *Associated Newspapers Ltd v FCT* (1938) 61 CLR 337; [1939] ALR 10; BC3900038.
6. *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634; [1946] ALR 434; BC4600017.
7. Above n 1, at [22].
8. Above n 1, at [66].
9. Above n 1, at [73].
10. Above n 1, at [80].
11. Above n 1, at [140].
12. Above n 1, at [81].
13. Above n 1, at [83].
14. Above n 1, at [59].
15. Above n 1, at [66].