Full Federal Court confirms Government grant is an assessable recoupment within tax law

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In brief

In the recent decision in *Denmark Community Windfarm Ltd v Commissioner of Taxation [2018] FCAFC 11* (**Denmark Community Windfarm**), the Full Federal Court held that a Commonwealth Government grant to partially fund the construction of wind turbines was an assessable recoupment within the meaning of tax law. Under the assessable recoupment provisions, an amount received as a recoupment of deductible expenditure is required to be returned as assessable income in the year of receipt, or over the period for which deductions can be claimed.

In detail

The Denmark Community Windfarm matter primarily concerned the scope to which the assessable recoupment provisions in Subdivision 20-A of the *Income Tax Assessment Act 1997* (**ITAA 1997**) applied to the Commonwealth grant received by the taxpayer (Denmark Community Windfarm). The grant was received from the Commonwealth Government to fund 50 per cent of the cost of construction of two wind turbines. Deductions for the cost of construction were available under the capital allowance provisions in Division 40 of the ITAA 1997. Having sought and obtained a private ruling confirming that the grant was neither assessable as ordinary income (under section 6-5 of the ITAA 1997) nor as a bounty or subsidy (under section 15-10 of the ITAA 1997), the taxpayer argued in Court that the grant was not an assessable recoupment under section 20-20 of the ITAA 1997.

Assessable recoupments

The rules dealing with the treatment of assessable recoupments (Subdivision 20-A of the ITAA 1997) provide that a recoupment of deductible expenditure is assessable income. However, Subdivision 20-A only has effect where the income is not otherwise ordinary income or statutory income, thereby operating as a provision of last resort.

The rules broadly capture two types of recoupments:

- Amounts received by way of insurance or indemnity, where the taxpayer can deduct an amount for the loss or outgoing in the current year or an earlier year under any provision of the tax law (**the first test**); and

- Any other recoupment of a loss or outgoing, where the taxpayer can deduct an amount for the loss or outgoing in the current year, or an earlier year, under a specified list of provisions of the tax law (**the second test**).

Denmark Community Windfarm argued that the grant did not satisfy either of these tests on the basis that:

- the grant was not received by way of indemnity or insurance (hence failing the first test);
- it did not claim any deductions for the loss or outgoing (having claimed deductions for depreciation or decline in value as opposed to the actual loss or outgoing), and
- the simplified depreciation rules (in Subdivision 328-D of the ITAA 1997), under which it claimed its depreciation deductions are not included in the specified list of provisions relevant for the second test (even though Division 40 of the ITAA 1997, containing the general rules for depreciation, is included in the list).

The Full Court found for the Commissioner on all aspects, concluding that the grant was received by way of indemnity and, that under the proper construction of the relevant provisions, a deduction for depreciation was a deduction for the cost of the relevant depreciating asset (the loss or outgoing). Hence the conditions of the 'first test' were met.

The Full Court also noted that, whilst not necessary given its conclusion on the first test, the grant also met the conditions of the second test as Denmark Community Windfarm *was able to* deduct an amount for the loss or outgoing under a listed provision (that is, Division 40 of the ITAA 1997) which is all that is necessary for the purposes of the test.

Amounts received by way of indemnity

The Full Court considered a number of previous cases that dealt with the application of section 20-20 of the ITAA 1997, and specifically the meaning of amounts received 'by way of indemnity'.

The Full Court noted that while this phrase may have been intended to apply broadly, the majority of the High Court in *Federal Commissioner of Taxation v Rowe [1997] HCA 16* rejected the general principle that an amount received by a taxpayer to compensate for an item that has previously been allowed as a deduction was assessable. In addition, the Full Court noted previous case law had established that a payment will generally not be regarded as an indemnity unless the entitlement to its receipt precedes the event in respect of which it is paid.

In the present case, the grant was received pursuant to an agreement with the Western Australian Coordinator of Energy to provide funding as part of the Commonwealth's Renewable Remote Power Generation Program. The agreement provided that the grant was to meet 50 per cent of the costs incurred in construction of the wind turbines, up to a specified maximum. Given these circumstances, the Full Court held that:

> *"... the amounts received by Denmark fell within the ordinary meaning of the word 'indemnity', which includes, as noted by the primary judge at [50], "a sum of money paid to compensate a person for liability, loss or expense incurred by the person". The fact that the amounts were a government subsidy or rebate does not affect the position. The amounts nevertheless bear the character of compensation for a liability, loss or expense incurred."*

Deduction for the loss or outgoing

A critical element of the first test is that the taxpayer can deduct an amount for the loss or outgoing for the current year, or an earlier income year, under any provision of the Act.

The Full Federal Court rejected the taxpayer's argument that it did not claim any deductions 'for the loss or outgoing' on the basis the deduction allowable under Division 40 or Subdivision 328-D of the ITAA 1997 relates to the decline in value of the depreciating asset. In doing so, the Full Federal Court came to the conclusion that the phase 'for the loss or outgoing' was sufficiently broad to pick up depreciation deductions where the relevant outgoing is the cost of the depreciating asset.

The reasons for the decision provided by the Court included:

- Depreciation deductions under Division 40 are deductions for the 'cost of a depreciating asset' which are spread over the effective life of the asset. Therefore, a depreciation deduction under Division 40 or Subdivision 328-D of the ITAA 1997 may be said to be a deduction of an amount 'for' that loss or outgoing.

- The specific inclusion of Division 40 in the table in section 20-30 of the ITAA 1997 supports the construction that deductions for the cost of a depreciating asset is a deduction 'for the loss or outgoing'.

- The construction favoured by the Full Federal Court is consistent with the purpose of the provisions. That is, the Court favoured an interpretation which aligned the taxpayer's deductions for a depreciating asset with its financial and economic cost of the asset.

The takeaway

Taxpayers need to take care when entering into monetary compensation arrangements in respect of the construction of assets, as the Full Federal Court's decision in Denmark Community Windfarm gives a broad operation to the 'first test' in the assessable recoupment provisions which can apply to amounts which are deducted under a provision of the Act that is not listed in the table in section 20-30 of the ITAA 1997 (such as, for example, Division 43 deductions for capital works).

It is also worth noting that this case did not address the other critical feature of the assessable recoupment provisions, being section 20-40 of the ITAA 1997 which deals with the timing of the recoupment. Practically, the operation of this provision in respect of a single asset means that there is a mismatch between the timing of a taxpayer's income and deductions. That is, the whole of the depreciation deduction in an income year is subject to recoupment, and not just the portion that relates to the recouped cost.

Our recent experience with the Australian Taxation Office (ATO) on Government grants or subsidies indicates that the ATO's approach to the taxation of such amount is evolving. The private ruling issued by the ATO to Denmark Community Windfarm that section 6-5 or section 15-10 of the ITAA 1997 does not apply to tax a 'commencement of business grant' may not represent the current ATO approach, notwithstanding Taxation Ruling 2006/3. To the extent the grant was otherwise assessable, then the assessable recoupment provisions would not apply.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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