

## **Concessions Fees as Allowable Deductions: Commissioner of Taxation v Citylink Melbourne Limited**

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This paper looks at the 2006 High Court decision of Commissioner of Taxation v Citylink Melbourne Limited [2006] HCA 35. The case concerned a much-litigated area of taxation law: whether certain expenses are revenue and thus deductible or capital and therefore not deductible. The case also looks at the concept of whether a deduction is 'incurred' and 'properly referable' to the income years in question. On the facts of the case Citylink Melbourne Limited (Citylink) entered into a number of contracts with the State of Victoria under which they were required to design, construct, operate and maintain a system of roads which were then subject to tolls. Citylink paid concession fees in consideration for the right to do all that was necessary to complete these tasks. This was done with a view to transferring these rights back to the State on completion of the infrastructure. Citylink claimed these concession fees as deductions on the basis that the fees were incurred on revenue account as there was no permanent acquisition of ownership rights over the roads and land. The Commissioner of Taxation rejected such a claim on the basis that the payment of the concession fees was on capital account and therefore not deductible. The issue for the Court was whether the concession fees were allowable as a deduction or more properly defined as capital. The Court decided that the concession fees were incurred in the income years in question on revenue account, and therefore constituted allowable deductions. Given this decision the case raises a number of important issues in relation to outgoings classified as deductions. In particular, the case highlights that the income/capital dichotomy remains a current issue between business and the Commissioner of Taxation.

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## I INTRODUCTION

This paper looks at the 2006 High Court decision of *Commissioner of Taxation v Citylink Melbourne Limited* [2006] HCA 35. The case concerned a much-litigated area of taxation law: whether certain expenses are revenue and thus deductible or capital and therefore not deductible. The case also looks at the concept of whether a deduction is ‘incurred’ and ‘properly referable’ to the income years in question. On the facts of the case, which are quite complex, Citylink Melbourne Limited (Citylink) entered into a number of contracts with the State of Victoria under which they were required to design, construct, operate and maintain a system of roads which were then subject to tolls. Citylink paid concession fees in consideration for the right to do all that was necessary to complete these tasks. This was done with a view to transferring these rights back to the State on completion of the infrastructure. Citylink claimed these concession fees as deductions on the basis that the fees were incurred on revenue account as there was no permanent acquisition of ownership rights over the roads and land. The Commissioner of Taxation rejected such a claim on the basis that the payment of the concession fees was on capital account and therefore not deductible. The issue was litigated before a single judge of the Federal Court, the Full Bench of the Federal Court and then before the High Court. The issue before each of the Courts was whether the concession fees were allowable as a deduction or more properly defined as capital. Ultimately, The High Court decided that the concession fees were incurred in the income years in question on revenue account, and therefore constituted allowable deductions. Given this conclusion by the High Court, the case raises a number of important issues in relation to outgoings classified as deductions. In particular, the case highlights that the income/capital dichotomy remains a current issue between business/industry and the Commissioner of Taxation.

## II THE CITY LINK PROJECT

The City Link Project, to extend Melbourne’s freeway network, was a \$3 billion project which was the largest urban infrastructure project in Australia. The preferred bidder was the Transurban consortium which comprised of an unincorporated joint venture between Transfield Holdings Pty Ltd and Obayashi Corporation. Transurban City Link Limited (Transurban) was subsequently registered as a public company limited by shares. The Concession Deed, which set out the payment of the concession fees which are the subject of this case, was executed by the State of Victoria, Transurban and other parties on 20 October 1995. This Concession Deed was subsequently amended a number of times between that time and 28 June 2002. The Concession Period under the Concession Deed commenced on 4 March 1996 at the date of financial closing. The Concession Period then extended for 33 years and 6 months after the Citylink Expected Completion date of 14 July 2000. The completion of the Concession Period is therefore 14 February 2034.

The City Link Project was to design and construct a road link connecting three of the four main Melbourne freeways.<sup>1</sup> The Project consisted of a number of component parts. On completion these parts would constitute toll roads with tolls to be collected via an Electronic Toll Collection System. Tolling commenced in 2000 on all parts of the City Link Project despite some parts being open to traffic at an earlier date.

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<sup>1</sup> *City Link Melbourne Limited (ACN 070 810 678) v Commissioner of Taxation* [2004] FCAF 272 [4].

The City Link Project was enabled under the *Melbourne City Link Authority Act 1994* (Vic) and the *Melbourne City Link Act 1995* (Vic). The *Melbourne City Link Act 1995* (Vic) provided ratification of the Concession Deed, as if enacted, and provided legislative support for various aspects of the City Link Project.<sup>2</sup> The legislation also provided for the payment of tolls in relation to the Link and created a penalty offence in the event of a person evading the payment of tolls.<sup>3</sup>

The Concession Deed provided that Transurban was charged with the finance, design and construction, operation, maintenance and repair of the link. The obligations of the State of Victoria were to contribute the land to be used in the project and to coordinate approvals from other State authorities to enable the link to be constructed and operated.<sup>4</sup> The land required for the City Link Project was the subject of a licence for which rental of \$100 per annum was payable by Transurban during the operations phase. The Concession Deed required Transurban to pay concession fees to the State in consideration for the State granting the concession with such concession fees payable for the full term of the Concession Period. The Concession Deed also allowed that the Concession Period only continued for as long as the concession fees were paid. The base concession fee was an amount of \$95.6 million and is payable semi-annually in arrears, in June and December. Additional concession fees were payable if toll revenue exceeded projections as set out in the Base Case Financial Model.

Financing of the project was necessarily complex. However, Transurban could issue Concession Notes to the State in satisfaction of its obligation to pay the base concession fees by virtue of the operation of the Master Security Deed. Such Concession Notes were for the value of the concession fee. There was also provision that the Concession Notes could not be presented for payment as long as there is Project Debt outstanding unless the Distributions Account contains sufficient money to meet the payment in full.<sup>5</sup> Due to a decrease in traffic volumes as compared to the financial models prepared by the financiers such redemption was not expected until close to 2034 rather than the earliest possible redemption date of 2013.

### III THE PRIMARY DECISION

The Commissioner disallowed the objection of Transurban to the amended assessment of income tax in respect of the year of income ended 30 June 1998.<sup>6</sup> Transurban disagreed with the disallowal and brought proceedings before the Federal Court. The initial appeal to the Federal Court was against an appealable objection decision of the Commissioner of Taxation. The appeal concerned whether annual concession fees payable by Transurban in relation to a concession to design, construct and operate Melbourne City Link were allowable deductions in relation to the 1996, 1997 and 1998 years of income. The applicable sections which related to the deductions were Section 51(1) of the *Income Tax Assessment Act 1936* (“the 1936 Act”) in relation to the years of income ending 30 June 1996 and 30 June 1997 and Section 8-1 of the

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<sup>2</sup> Ibid [7].

<sup>3</sup> Ibid.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid [19].

<sup>6</sup> *Transurban Citylink Limited v Commissioner of Taxation* [2004] FCA 40 [3].

*Income Tax Assessment Act 1997* (“the 1997 Act”) in relation to the year of income ending 30 June 1998.<sup>7</sup>

Section 51 (1) provides for the following:

All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

Thus, the first issue that arose out of the appeal to the Federal Court concerns whether the concession fees are losses or outgoings ‘incurred’ in the 1996, 1997 and 1998 years of income. The Commissioner contended that the obligation to pay the fees constituted a contingent obligation. The contention of Transurban was that the obligation to pay the concession fees constituted an unequivocal positive obligation. They claimed that the ability to defer payment of the fees did not detract from the absolute nature of the obligation to pay them nevertheless. Justice Merkel found that Transurban had ‘completely subjected and definitively committed itself to paying the amounts due in respect of the concession fees’.<sup>8</sup> Justice Merkel further found that the liability to pay the concession fees arose unconditionally in each of the income years under the relevant clause of the Concession Deed and satisfaction of this liability arose when Transurban elected to issue Concession Notes ‘under which there was also a present liability to pay the amounts due at a future time’.<sup>9</sup> Thus, the liability in relation to the relevant income years had been ‘incurred’.

The second issue that arose as a consequence of the decision in relation to the first issue was whether the concession fees were properly referable to the 1996, 1997 and 1998 years of income. The contention of the Commissioner was that the amounts were properly referable to the years in which the payments will be made as opposed to the years in which the liability was incurred which was the contention of Transurban. Justice Merkel held that the concession fees were on revenue account and as the liability for the fees arose semi-annually then the outgoings in respect of these fees would be referable to this semi-annual period as well. Justice Merkel noted that ‘if the Notes were treated as referable to the year or years of income in which the payment is made that would lead to a distortion of Transurban’s operations on revenue account in that year or those years’.<sup>10</sup> Having said that, Justice Merkel further noted that this may lead to an anomalous outcome which ‘might be seen to be something that might only be expected in a taxpayers’ heaven’.<sup>11</sup>

Justice Merkel then turned to the issue of whether the fees were on revenue account or capital account. In this regard the contention of the Commissioner was that the fees

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<sup>7</sup> Both sections essentially provide for the same outcome as Section 8-1 of the 1997 Act is merely a rewritten version of Section 51(1) intended to provide a plain English version of the original provision.

<sup>8</sup> *Transurban Citylink Limited v Commissioner of Taxation* [2004] FCA 40 [75].

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid* [82].

<sup>11</sup> *Ibid* [84].

were paid in return for the grant of a monopoly excluding all those other than Transurban from any privileges, entitlement and benefits of the City Link Project. In the alternative the Commissioner argued that the concession fees entitled Transurban to establish a business from which the State ensured freedom from competition. These arguments would result in the concession fees being in the nature of capital and therefore not deductible to Transurban. The argument of Transurban contended that the payments were clearly of a revenue nature as they were recurrent, payable semi-annually and made for the periodic use of the City Link infrastructure. Justice Merkel found that an examination of the *Melbourne City Link Act 1995* (Vic) and the Concession Deed was not supportive of the Commissioner's contention and that no competitive advantage was conferred on Transurban by payment of the concession fees.

The final issue that arose in relation to payment of the concession fees was whether the concession fees were akin to a sharing of profit or payment of a dividend. This issue required consideration of whether the contribution of the State to the City Link Project was one that should be properly characterised as being an advantage enuring to capital. The Commissioner contended that there was, in effect, a joint venture between the State, Transurban and others in relation to the City Link Project. Returns in relation to this joint venture were then designated to be paid firstly to the creditors and the Equity Investors with the remains then being shared between the investors and the State. Transurban argued, in a similar argument to that in relation to the capital characterisation issue, that the concession payments were merely payments made to secure periodic use of the rights to City Link and that they do not represent a share of the profits from operating the City Link. After extensive consideration of the documentation in relation to payment of the concession fees, including the pre-contractual negotiations, Justice Merkel concluded that the concession fees are akin to a share of profit and also to payment of a dividend of a fixed and predetermined amount. Justice Merkel also considered what the payments described as concession fees were actually payments for, and concluded that the concession fees were paid for, the advantages conferred upon Transurban by the State. As the advantages granted allowed the State to grant the concession and were necessary for the operation and establishment of City Link they 'formed part of the profit yielding structure of City Link'<sup>12</sup> and therefore should be properly characterised as being advantages enuring to capital. Justice Merkel also stated that in the alternative the concession fees are of a capital nature because the contributions by the State which the concession fees are paid in relation to 'are of enduring benefit, are of a "once and for all" nature and form part of the profit yielding structure of City Link'.<sup>13</sup> This resulted in the concession fees being characterised as being on capital account rather than on revenue account which means that the losses or outgoings paid in relation to the concession fees are not allowable deductions.

#### IV FEDERAL COURT APPEAL

An appeal was made to the Full Court of the Federal Court by City Link Melbourne Limited, which was the company formerly named Transurban City Link Limited. The Full Court, constituted by Justices Hill, Stone and Allsop, agreed with the Primary

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<sup>12</sup> Ibid [175].

<sup>13</sup> Ibid [191].

Judge, Justice Merkel, that Transurban had ‘completely subjected and definitively committed itself’<sup>14</sup> to payment of the concession fees in each year of income. The Full Court held that even though the payment of the amounts was not required until well into the future this did not prevent the concession fees from being incurred. Alternatively, it was noted that the Concession Notes, which operated as payment in full of the amounts of the concession fees, operated to discharge the liability that arose in relation to the concession fees. The conclusion of the Full Court on the first issue was that ‘on any view of the matter it would follow that the obligation to pay the Concession Fee was incurred in the year of income’.<sup>15</sup>

The second issue was whether the concession fee was referable to the year of income. Applying the principles of referability in *Coles Myer Finance Limited v Commissioner of Taxation of the Commonwealth of Australia*<sup>16</sup> the Full Court found that the concession fees should be treated as a liability which was both incurred in the year of income in which the liability arose and was referable to that year of income.

The third and fourth issues could then be decided to either reinforce the decision that the concession fees were allowable deductions or if they were found to be akin to a sharing of profits or of a capital nature then this would preclude the finding that they were allowable deductions.<sup>17</sup> The third issue then was whether the payment of the concession fees constituted a sharing of profits which would therefore make them non-deductible. The Full Court found that Justice Merkel had erred in considering the contents of pre-contractual negotiations as being relevant in finding that the payments were akin to a sharing of profits. The Full Court also found that Justice Merkel erred in deciding that the State of Victoria and Transurban were parties to a joint venture. It was held by the Full Court that neither of these considerations was relevant and that the real issue that would preclude the concession fees from deductibility would be the issue of whether or not they constituted outgoings of capital.

The concession fees are paid by Transurban in return for a bundle of rights being granted by the State of Victoria. The rights that are referred to in the relevant clause of the Concession Deed are the rights to design, construct, commission, operate and maintain and repair the City Link. In addition the Concession Deed gives Transurban the right to impose and collect a toll and raise revenues in relation to the use of vehicular traffic on the City Link. It is in return for these rights that the concession fees are paid. In the opinion of the Full Court the initial rights in relation to the design, construction and commissioning of the project are more in the nature of obligations. As these obligations give rise to ‘an advantage of an enduring kind’<sup>18</sup> payments in relation to these would be payments of capital. Consideration of the design and construction phase of the Project separate to the operations phase of the Project would give rise to the possibility of apportionment. However, the possibility of apportionment was struck out by the Commissioner. In the opinion of the Full Court the payment of the concession fees were therefore paid in relation to the rights

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<sup>14</sup> *City Link Melbourne Limited (ACN 070 810 678) v Commissioner of Taxation* [2004] FCAFC 272 [32].

<sup>15</sup> *Ibid* [34].

<sup>16</sup> (1993) 176 CLR 640.

<sup>17</sup> *City Link Melbourne Limited (ACN 070 810 678) v Commissioner of Taxation* [2004] FCAFC 272 [40].

<sup>18</sup> *Ibid* [66].

to operation of the City Link Project to be considered separately to the rights of construction. The Full Court found that Justice Merkel erred in considering the concession fee as being payable in relation to the establishment and maintenance of the Transurban's business structure rather than the operation of the business. Justice Merkel also considered the six monthly concession fees as being one 'single concession fee'. The Full Court found that the concession fees were more properly characterised as being 'periodical and recurrent'<sup>19</sup> and therefore a cost of the operation of the business rather than a cost of acquisition. The amount of the concession fees were therefore allowable deductions rather than an amount of capital.

## V THE HIGH COURT CASE

The Commissioner of Taxation then appealed to the High Court. The Court was constituted by Chief Justice Gleeson and Justices Gummow, Callinan, Heydon and Crennan in the majority and Justice Kirby in the minority. Justice Kirby, giving the dissenting judgement, of the High Court of Australia firstly gave consideration to the issue of whether or not the concession fees were of a capital nature and therefore not deductible or of a revenue nature and therefore deductible. Justice Kirby, in his judgement, agreed with the findings of Justice Merkel on this issue and found that the Full Court of the Federal Court had erred in finding that the bundle of rights for which the concession fees were paid could be disaggregated. In the opinion of Justice Kirby the concession fees 'were not incurred in consideration of the right to operate the tollway separately from the other rights'.<sup>20</sup> Rather they were incurred 'for a significant capital asset indispensable to the Project'.<sup>21</sup> Thus, the concession fees were outgoings of a capital nature.

Justice Kirby also found that the concession fees were not incurred in the income years on the basis that the liability of Transurban to the concession fees had not 'come home'<sup>22</sup> during that time. In any case Justice Kirby also found that the concession fees were not properly referable to the years of income as they constituted a future expense.

The majority judgement was handed down by Justice Crennan with Chief Justice Gleeson and Justices Gummow, Callinan and Heydon in agreement. On the issue of whether the concession fees were incurred in the years of income Justice Crennan found that the 'liability arose as and when each concession fee became due'.<sup>23</sup> Transurban had 'definitively committed'<sup>24</sup> and 'completely subjected itself to the losses or outgoings'<sup>25</sup> represented by the concession fees. On that basis the concession fees represented losses or outgoings that were incurred in the relevant years of income.

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<sup>19</sup> Ibid [71].

<sup>20</sup> *The Commissioner of Taxation of the Commonwealth of Australia v Citylink Melbourne Limited* [2006] HCA 35 [33].

<sup>21</sup> Ibid [34].

<sup>22</sup> *Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616, 623.

<sup>23</sup> *The Commissioner of Taxation of the Commonwealth of Australia v Citylink Melbourne Limited* [2006] HCA 35 [134].

<sup>24</sup> Ibid [137].

<sup>25</sup> Ibid.

On the question of whether the concession fees were referable to the years of income Justice Crennan found that concession fees are similar to licence fees which give access to capital assets for a limited period after which the capital asset is to be surrendered back to the State. The advantages secured by the concession fees clearly ‘come home’<sup>26</sup> in the relevant income years. Therefore, the concession fees are properly referable to the income years in question.

The final issue was whether the concession fees were on capital account and not deductible or whether they should properly be characterised as being on revenue account and therefore deductible. Justice Crennan found that as the concession fees are payable during the concession period only and do not give permanent ownership rights to Transurban they are properly characterised as being on revenue account and therefore allowable as deductions.

## VI CONCLUSION

The Citylink case involved concession fees being paid for a bundle of rights in relation to the Citylink project. These concession fees gave Transurban the right to design, construct, commission, operate, maintain and repair the Citylink project but did not give permanent ownership of the structure. The concession fees were found by the majority of the High Court to be on revenue account. Despite years of judicial consideration in relation to what expenditure constitutes revenue and what expenditure constitutes capital the facts and circumstances of each case will still dictate the outcome. In this case, the arrangements put in place to finance the project were extremely complex. This complexity contributed to the need for this case to be decided by the High Court. Perhaps prudence would dictate that further arrangements of this nature use a less complex financial structure to reduce the likelihood of a long and drawn out court battle with the Commissioner of Taxation occurring. It appears that the income/capital dichotomy is still alive and well despite the extensive judicial consideration that has occurred and careful consideration should be given to this when engaging in tax planning.

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<sup>26</sup> *Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616, 623.