

## Topic 3 Derivation – Small Business Entities -- Ordinary Income

### Objectives

Understand ordinary income – principles:

- Derivation
- Must be convertible into money
- Principle of mutuality
- Periodical gains
- Windfall gains
- Receipts illegal activities
- Gains from use of property
- Personal services receipts
- Business Income
- Capital Receipts
  - Gains from the sale of property
  - Restrictive covenants are generally not income
  - Gains which constitute compensation for income, have the character of income
  - Undissected lump sums must be apportionable

### 1. Derivation

#### Tax period

The tax year generally commences on 1 July of a year and ends on 30 June of the following year. Under ITAA 1936 s 18 a taxpayer can apply to the Commissioner to have a substituted accounting period (SAP). This will be accepted where the 30 June tax year is clearly inappropriate for the taxpayer: see Taxation Ruling IT 2360. For most taxpayers, the tax year ends on 30 June of each year.

The current tax period is the year 1 July 2013 to 30 June 2014.

#### Timing of income

Subsections 6-5(2) and (3) ITAA 1997 require that you include your ordinary income derived directly or indirectly during the income year. Other sections dealing with timing are subs 6-5(4) (deemed derivation) and subs 6-10(3) (timing of statutory income).

**Online Activity 1** : Read ITAA 1997 ss 6-5 and 6-10

## **Meaning of derived**

Derived is not defined in the ITAAs, so you need to use the method of accounting that reflects the taxpayer's true income: see *Commissioner of Taxes (SA) v Executor, Trustee and Agency Company of South Australia Ltd* (Carden's Case). The timing of derivation depends on the type of income and taxpayer.

## ***Salary and wages***

Salary and wages are derived when received: see *Brent v FCT* 71 ATC 4195. Where an employee agrees to forgo part of salary for paid leave in a later period the deferred salary is assessable when received (derived). Similarly, back pay is derived when received. Where an amount is credited to an employee and can be drawn at any time, it is derived at the time of crediting: see *Garforth v Newsmith Stainless Ltd* (1979) 2 All ER 73.

Also, acceptance of a cheque constitutes payment (see *Nicks Ltd v Taylors Ltd* [1962] NZLR 286) even if post-dated: see *Marreco v Richardson* [1908] 2 KB 584. If an employee refuses to receive a cheque until after 30 June, the cheque will be derived when tendered to the taxpayer: see *Case D62 72* ATC 4195.

**Online Activity 2**: Read *Brent v FCT* 71 ATC 4195

## ***Interest***

Interest is generally derived when received or credited: see *Leigh v IRC* (1927) 11 TC 590. Note: accruals is appropriate for a bank or financier: see *CIR (NZ) v National Bank of New Zealand* 77 ATC 6001.

## ***Rent***

Rent is generally derived when it is received, although the situation is not clear for rent received in advance. You will need to examine the lease agreement and the factors set out at prepaid income below at 4.15. If a taxpayer is carrying on a business of renting out properties or other assets then the accruals basis will be appropriate.

## ***Income from professional practices***

Establishing the derivation of income from professional practices, such as accounting and law firms and medical practices, may involve some uncertainty, as you need to weigh up the relevant factors in determining cash or accruals basis, as outlined in TR 98/1: size of business; circulating capital and consumables; the use of capital items to produce income; credit policy and debt recovery and books of account.

The courts have established, though, that a small sole practitioner professional practice should use the cash basis: see *Carden's case*; *FCT v Firstenberg* 76 ATC 4141; *FCT v Dunn* 89 ATC 4141.

A large professional practice should use the accruals basis: see *Henderson v FCT* (1970) 119 CLR 612; 70 ATC 4016.

However, there is no clear authority for medium-sized professional firms as to whether cash or accrual is appropriate.

**Online Activity 3:** Read *Carden's* case

### ***Income from business***

The question remains from *Carden's* case as to what method of accounting provides a substantially correct reflex of the taxpayer's true income in respect of business taxpayers. In *J Rowe & Son Pty Ltd v FCT*, Menzies J noted that accruals accounting principles should apply to the income tax accounting of business income. This is further supported by the Commissioner in Taxation Ruling TR 98/1.

There is a further principle that must be followed for business income. That is, to be earned and therefore derived, a recoverable debt must be created such that a taxpayer is not required to take further steps before becoming entitled to payment: see *FCT v Australian Gas Light Co* 83 ATC 4300.

If part of the consideration received by a business cannot be ascertained due to a dispute, then the income is derived when the dispute is resolved: see *BHP Billiton v FCT* 2002 FCA 189.

### ***The former simplified tax system***

From 1 July 2001 to 30 June 2005, small business taxpayers could elect to join the Simplified Tax System (STS) and adopt a cash basis for accounting for income. These rules have been grandfathered, thus former STS taxpayers may be able to continue to use cash-basis accounting for income.

### ***Prepaid income***

There exists some opportunity to defer assessable income if the income is subject to a contingency and treated as a liability in the books: see *Arthur Murray (NSW) Pty Ltd v FCT*.

### ***Deemed derivation: ss 6-5(4) and 6-10(3)***

For both ordinary and statutory income, you are taken to have derived the income as soon as it is applied or dealt with in any way on your behalf or as you direct: see ss 6-5(4) and 6-10(3).

Where a pension was directed by the taxpayer to his wife, the taxpayer still had to include the pension in his assessable income: see *Case U52 87 ATC 347*.

Note: deemed derivation provisions do not apply, however, where a debtor refrains from making payment at the request of a creditor: see *Brent v FCT* (1971) ATC 4195 at 4201.

## 2. Ordinary Income

The ITAA 1997 is based on calculating taxable income and then applying the tax rate to calculate tax payable. Taxable income is calculated by the equation, assessable income minus deductions: see s 4-15. There are two types of assessable income: ordinary income and statutory income. This topic focuses on what constitutes ordinary income: see ITAA s 6-5 1997.

Traditionally Australia has relied on an income tax base that centred on ordinary income: see s 6-5. However, income tax laws failed to define income, leaving that task to the courts. The courts have broadly defined income as a flow from a source of earning activity, such as wages, interest, rent and business income. In keeping with trust law concepts of income the courts considered that capital receipts do not constitute assessable income. The opinion of Pitney J in *Eisner v Macomber* 252 US 189 (1920) became the benchmark for describing this flow concept of income in many Australian income tax cases.

In *FCT v Montgomery* 99 ATC 4749 the majority (Gaudron, Gummow, Kirby and Hayne JJ) provided a good explanation of ordinary income as follows:

61. In 1991 and 1992, the *Income Tax Assessment Act 1936* (Cth) ("the Act") contained no definition of income, although it did define "income from personal exertion or income derived from personal exertion" and "income from property or income derived from property".[36] Income from (or derived from) personal exertion was defined as meaning (in part):

"... income consisting of earnings, salaries, wages, commissions, fees, bonuses, pensions, superannuation allowances, retiring allowances and retiring gratuities, allowances and gratuities received in the capacity of employee or in relation to any services rendered, the proceeds of any business carried on by the taxpayer either alone or as a partner with any other person, any amount received as a bounty or subsidy in carrying on a business... any profit arising from the sale by the taxpayer of any property acquired by him for the purpose of profit-making by sale or from the carrying on or carrying out of any profit-making undertaking or scheme... but does not include:

(a) interest, unless the taxpayer's principal business consists of the lending of money, or unless the interest is received in respect of a debt due to the taxpayer for goods supplied or services rendered by him in the course of his business; or

(b) rents or dividends."

Income from (or derived from) property was defined as meaning "all income not being income from personal exertion".

62. The distinction between income from personal exertion and income from property was important when the two forms of income were taxed at different rates[37] and the distinction has been drawn for other purposes.[38] But the definition of income from personal exertion "has always been used as a possible guide or test in cases where the question is whether a

particular receipt is income or not".[39] The definition of income from personal exertion thus casts some light on what was meant by the Act when it said in s 25(1) that:

“The assessable income of a taxpayer shall include-

(a) where the taxpayer is a resident-

the gross income derived directly or indirectly from all sources whether in or out of Australia; and

(b)...

which is not exempt income...”

But both of the definitions in s 6 (of income from personal exertion and income from property) begin by saying the term “means income...” or “means all income...”. Both definitions, therefore, presuppose that “income” has a meaning. It follows, then, that the question what is income cannot be answered simply by resorting to the words of these definitions.

63. Nearly a century ago Lord Macnaghten begged pardon for reminding his listeners that “[i]ncome tax... is a tax on income. It is not meant to be a tax on anything else”.[40] But, as Jordan CJ said in *Scott v FC of T*: [41]

“The word ‘income’ is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts.”[42]

64. Because the distinction between income and capital has so often been considered by the courts, attempts to classify a particular receipt often proceed by seeking to draw analogies with decided cases.[43] That approach is often helpful, but resort to analogy should not be permitted to obscure the essential nature of the inquiry which is to determine whether “in ordinary parlance” the receipt in question is to be treated as income. As Jordan CJ made plain, the references to “ordinary parlance” and to the “ordinary concepts and usages of mankind” are no mere matters of ritual incantation; they identify the essential nature of the inquiry.

65. The core of the meaning of “income” in a context such as the present can be identified from what was said by Pitney J in the opinion of the Supreme Court of the *United States in Eisner v Macomber*: [44]

“The fundamental relation of ‘capital’ to ‘income’ has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term ‘income,’ as used in common

speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use (Bouv L D; Standard Dict; Webster's Internat Dict; Century Dict), we find little to add to the succinct definition adopted in two cases arising under the *Corporation Tax Act of 1909* (*Stratton's Independence v Howbert*, 231 US 399, 415; *Doyle v Mitchell Bros Co*, 247 US 179, 185) - 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle Case* (pp 183, 185).

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. 'Derived-from- capital'; - 'the gain-derived-from-capital,' etc. Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; - that is income derived from property. Nothing else answers the description." [45]

66. As was noted in *FC of T v Myer Emporium Ltd*,[46] both the "ordinary usage meaning" of income and the "flow" concept of income derived from trust law have been criticised.[47] But both the ordinary usage meaning and the flow concept of income are deeply entrenched in Australian taxation law and it was not suggested by either party that there should be any reconsideration of them. Nor was it suggested that they should be replaced by concepts of gain or realised gain,[48] concepts that some economists consider preferable.

67. What can be seen from the passage from *Eisner v Macomber* is that income is often the product of exploitation of capital. But, of course, that is not always so. The worker's wages are not (except figuratively) the product of exploitation of the worker's capital. Further, as has so often been stated, income will frequently be recurrent or periodical. But again, the fact that a person only ever works for wages for one week, and receives but a single pay packet (or more likely written advice of electronic funds transfer) does not make the wages thus earned any the less income in the hands of the worker. Most receipts from carrying on a business are income. But some receipts, such as amounts paid on disposing of capital assets of the business, are properly classified as receipts on capital account.

68. Each of the general propositions we have mentioned is qualified: income is often (but not always) a product of exploitation of capital; income is often (but not always) recurrent or periodical; receipts from carrying on a business are mostly (but not always) income. Further, in a case where it is said that the receipt is from carrying on business, often there will be a real

and lively question whether what has been done amounts to carrying on business or is, in truth, no more than a singular transaction of purchase and resale of property.[49]

69. The search for analogous cases is, then, hardly surprising and was undertaken by both of the parties to this appeal. In doing so, each party tended to emphasise one or more features of the transactions that gave rise to the payments received by the firm. Sometimes the emphasis of one or more of these features was taken to the point of excluding any consideration of the other features of the transactions. But as Dixon and Evatt JJ said (in the more limited context of distinguishing between profits derived from carrying on or carrying out a profit-making scheme and proceeds of a mere realisation or change of investment[50]) ``it is necessary to make both a wide survey and an exact scrutiny of the taxpayer's activities".[51] We turn then to describe the transactions and their background in more detail.

#### Footnotes<sup>1</sup>

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<sup>1</sup> [33] *Montgomery v FC of T* 97 ATC 4287; 35 ATR 416.

[34] *Montgomery v FC of T* 98 ATC 4120; (1998) 152 ALR 241.

[35] 98 ATC 4120 at 4129; (1998) 152 ALR 241 at 244 per Davies J, ATC 4142; ALR 259 per Lockhart J, ATC 4127; ALR 266 per Heerey J.

[36] s 6(1).

[37] See, for example, s 8(1) of the *Income Tax Act 1974* (Cth) imposing a surcharge on income from property where the taxable income exceeded \$5,000.

[38] See, for example, the provisions governing the calculation of the rebate on dividends granted to resident companies under s 46 of the Act as it stood until the *Taxation Laws Amendment Act (No 2) 1987* (Cth).

[39] *FC of T v Dixon* (1952) 10 ATD 82 at 85; (1952) 86 CLR 540 at 555 per Dixon CJ and Williams J; see also

*Scott v FC of T* (1966) 14 ATD 286 at 292; (1966) 117 CLR 514 at 524 where Windeyer J said that the definition ``refers to what is already by its nature income".

[40] *London County Council v Attorney-General* [1901] AC 26 at 35.

[41] (1935) 3 ATD 142 at 144-145; (1935) 35 SR (NSW) 215 at 219.

[42] *A-G of British Columbia v Ostrum* [1904] AC 144 at 147;

*Lambe v Inland Revenue Commrs* [1934] 1 KB 178 at 182-183.

[43] *Van Den Berghs Ltd v Clark* [1935] AC 431 at 438-439 per Lord Macmillan.

[44] 252 US 189 at 206-207 (1920). The Supreme Court was construing the Sixteenth Amendment to the United States Constitution which stated:

**The courts have developed other principles for ordinary income resulting in the following categorisation of income by principles, as follows:**

***Convertible into money***

Ordinary income must be convertible into money. Obviously a cash payment of income will have a readily ascertainable income value, but what if the payment is in a non-cash form? The courts have applied the requirement in *Tennant v Smith* [1892] AC 150 and *FCT v Cooke & Sherden* 80 ATC 4140 that an amount must be convertible into cash to be income. Also see *Payne v FCT* 96 ATC 4407

To stop the proliferation of incentive schemes, ITAA 1936 s 21A was introduced for non-cash business benefits. The Fringe Benefits Tax Assessment Act 1986 is designed to tax non-cash benefits provided in respect of an employee/employer relationship.

**Online Activity 4:** Read *Cooke & Sherden* 80 ATC 4140

***The principle of mutuality***

The principle of mutuality reflects a principle that you cannot earn income off yourself. Income must be derived from external sources: see *Bohemians Club v Acting FCT* (1918) 24 CLR 334. This principle can be applied to groups of people: that is, clubs, in accordance with *Municipal Mutual Insurance Ltd v Hills* (1932) 16 TC 430. The requirements for the principle of mutuality are:

- Need a fund created and controlled by contributors for common purpose: see *Municipal Mutual Insurance Ltd v Hills* (1932) 16 TC 430.
- All contributors to the fund must be entitled to participate in the surplus.
- Trading profits are not covered by this principle, and receipts from non-members constitute income (need to apportion: see *Carlisle Silloth Golf Club v Smith* (1912) 6 TC 48.)

Receipts from non-members visiting the club or association will be assessable. Also, investment income of a club or association's funds, for example, bank interest, dividends and rental property income, is assessable income. In *North Ryde RSL v FCT* 2002 ATC 4293 the Federal Court found that commission income from a Keno licence constituted assessable income.

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“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

[45](Emphasis in original.) Although Holmes J (with Day J) and Brandeis J (with Clarke J) dissented, the dissenting opinions, powerful as they are in relation to the particular issue that fell for decision in the case, do not detract from the validity of the propositions advanced in the opinion of the Court.

### ***Periodical gains have the character of income***

One of the most common characteristics of income is periodicity and frequency. The courts have considered this characteristic as being important (not always essential, though) in determining income. Dixon provides longstanding authority for this principle see *FCT v Dixon* (1952) 86 CLR 540

**Online Activity 5:** Read *FCT v Dixon* (1952) 86 CLR 540

Periodicity is not essential, however, as there have been a number of cases where taxpayers have converted an income stream (that is, interest or royalties) to a lump sum and unsuccessfully argued that such assignments are of a capital nature

### ***Windfall gains***

Normally, unexpected lump sum gains are not income. Such payments can be categorised as follows.

### ***Gifts***

Gifts are prima facie not income: see *Hayes v FCT* (1956) 96 CLR 47 and *Scott v FCT* (1966) 117 CLR 514. In summary, the following principles have emerged from the courts:

- Gifts are not income, unless they are related to employment, income-earning or business activity.
- The test is objective, not subjective.
- The character of the payment in the hands of the recipient is important; the motive of the donor is only relevant.

**Online Activity 6:** Read *Hayes v FCT* (1956) 96 CLR 47

### ***Gambling winnings***

Gambling winnings are usually lump sum payments, isolated, unexpected, and have a degree of chance attached to them. Thus, courts have generally held that such winnings do not constitute income. The Full High Court in *Martin v FCT* (1953) 90 CLR 470 found that a gambler who made 602 bets, including 275 winning bets, during a three-year period did not carry on a business.

Sometimes taxpayers claim that they are carrying on a gambling business so they can claim losses. This is very difficult to establish, given the elements of chance involved and the pleasure motive. An exception, though, applies to gambling businesses such as bookmakers and casinos; such business proceeds are income.

### ***Lottery winnings***

Lottery winnings are not income, being lump sum amounts, isolated and having an element of chance.

Example: Emma wins X lotto and receives \$1 million, this is not ordinary income (being a windfall gain).

### ***Receipts from illegal activities***

The fact that a receipt arises from an illegal or immoral activity is totally irrelevant to whether it constitutes income: see *Partridge v Mallandaine* (1886) 2 †TC 179. Therefore, if the activities are systematic and producing a profit, or profit intention, then the gains will be viewed as income.

### ***Gains from the use of property***

Gains from the use or enjoyment of property by another person will be ordinary income: see ITAA 1997 s 6-5; *FCT v Montgomery* (1999) 198 CLR 639; 99 ATC 4749. Note that receipts relating to the sale of a capital asset (for example, selling property) generally do not constitute ordinary income.

Example: Andrew rents out a house, the rent is ordinary income (being a gain from the use or enjoyment of property by another person).

**Online Activity 7**: Read *FCT v Montgomery* (1999) 198 CLR 639

### ***Income from personal services has the character of income***

Almost exclusively, gains made from the product of services or employment will be income.

Although not every payment received by an employee will be income, the courts have established the following factors in determining whether gains from personal services or gifts are ordinary income:

- degree of connection to employment or services rendered
- reasonable expectation payment would be made
- dependence upon payment to meet usual living expenses
- payment replaces income
- motive of the payer or donor, that is, commercial considerations or personal reasons for making payment
- periodical, recurrent and regular
- money or convertible into money.

The most important factor is the connection between the receipt and the employment or services provided. The courts have classified this nexus as follows:

- receipts directly related to employment or services
- receipts incidental to employment or services
- receipts unrelated to employment or services.

Importantly, in determining this nexus, the courts look to the nature of the receipt in the hands of the recipient. Thus, it is vital to ascertain what the recipient has done in consideration for the receipt of money or property.

### ***Receipts directly related to employment or services***

Clearly, salary, wages, commissions are directly connected with employment services provided, and thus constitute income: see *AG of British Columbia v Ostrum* [1904] AC 144. Even if a lump sum payment is made to retain or obtain the services of a taxpayer, that payment will be income as it is directly related to services. A retention payment or a signing-on fee for a sports person is income: see *Dean v FCT* 97 ATC 4762.

Even if you try to disguise the form of the payment or the payment is made in an unusual manner, but if, in substance, the payment is directly related to personal services, the amount will be income: see *Reuter v FCT* 93 ATC 5030. Where the connection between the payments and services is not as strong, this requires a careful analysis of the facts and relevant cases.

Example: Peter work for BHP as a miner and earns \$200,000, this is ordinary income (being are directly connected with employment).

### ***Receipts incidental to employment or services***

Receipts that are incidental to employment or services may be income and regard must be had to the facts of the case and the relevant factors listed above. See *Kelly v FCT* 85 ATC 4283.

### ***Receipts unrelated to employment or services***

Where there is no connection between employment/services rendered and the receipt, such payments are not income. See *Hayes v FCT* (1956) 96 CLR 47, *Scott v FCT* (1966) 117 CLR 514 and *FCT v Harris* (1980) 10 ATR 869

**Online Activity 8**: Read *Dean v FCT* 97 ATC 4762

### ***Receipts from carrying on a business***

The first issue is whether the taxpayer is carrying on a business. Usually this will be obvious. The ITAA 1997 defines a business to include any profession, trade, employment, vocation or calling, but does not include occupation as an employee. This definition is merely inclusive and does not provide any guidance for determining whether a particular activity constitutes a business.

Carrying on a business is not defined, so the courts have developed a number of relevant characteristics for a business activity (see *Ferguson v FCT* 79 ATC 4261):

- nature of activities commercial or hobby
- a profit-making purpose exists

- profit is made from activities
- repetition and regularity of activities
- organisation of activities in business-like manner keeping of records, use of a system
- time engaged in activities
- volume of operations size and scale
- amount of capital used.

The above factors in *Ferguson* are not exhaustive. Accordingly, there is no definitive approach as to what constitutes a business. Rather, the determination of a business is the result of a process of weighing up of a number of relevant factors but this does not provide a definitive solution.

**Online Activity 9:** Read *Ferguson v FCT* 79 ATC 4261

**Example:** Rupert has a farm with 2000 sheep, this is a business (given the commercial nature, scale, time, profit purpose, capital, repetition).

**Example:** Amy has 5 acres of land and has 5 sheep and 1 horse, this is not a business (given the hobby nature and the lack of : scale, time, profit purpose, capital, repetition).

### **Whether a business receipt is income**

First, as noted above, business income must be derived and be convertible to money to constitute ordinary income. Second, whilst most receipts from carrying on a business will be income, not every business receipt will be income. There must be sufficient connection to the business activity: see *FCT v Spedley Securities Ltd* 88 ATC 4126. The courts have outlined relevant factors in determining sufficient connection as follows:

- connection to business activity
- reasonable expectation
- payment replaces income
- profit-making purpose
- periodical, recurrent and regular.

The most important factor is the degree of connection between the receipt and the business activity. The courts have classified this nexus:

- receipts received in the ordinary course of business
- receipts incidental to the ordinary course of business
- receipts from an extraordinary transaction.

### ***Receipts received in the ordinary course of business***

Gains that directly relate to the business activity will be income: see *Californian Copper Syndicate v Harris* (1904) 5 TC 159.

Eg: a supermarket sells fruit, vegetables and groceries, the receipts are ordinary income (directly relates to the business activity).

### ***Receipts incidental to the ordinary course of business***

If a receipt is incidental to carrying on a business it will be income: see *FCT v Reynolds* 81 ATC 4131 and *Esso Australia Resources v FCT* (1999) 201 CLR 49.

### ***Receipts from an extraordinary transaction***

Having regard to the general principles of income, it would appear at first blush that receipts from isolated or extraordinary transactions would not be income. Traditionally, case law supports the view that the mere realisation of an asset is not income: see *Scottish Australian Mining Co Ltd v FCT* (1950) 81 CLR 188. The High Court held that the profits were not income according to ordinary concepts and usages. The land was acquired to mine. The taxpayers subdividing activities did not constitute a land developing business. The taxpayer merely realised to its best advantage land, which had been acquired for mining coal not real estate dealing.

However, Myer Emporium established the very important principle that one-off lump sum receipts may constitute income. In *FCT v Myer Emporium Ltd* (1987) 163 CLR 199 the High Court held: The payment was income. If receipts gained in the ordinary course of business are income, it does not follow that receipts gained not in the ordinary course of business profit are not income. If there exists the intention to make profit it may be income; whether it does is a question of fact. The receipt was part of a profit-making scheme, thus, ordinary income. Myer Emporium principle requires:

- receipts gained not in the ordinary course of business will be income if there exists a profit-making intention
- must be carrying on a business and the transaction must relate to that business
- must have a profit-making purpose at the time the transaction is entered into.

In *Montgomery* 98 ATC 4120, Lockhart J, in the Full Federal Court, provided an apt summary of the relevant principles of Myer for determining whether a lease incentive payment constituted ordinary income (a yes answer means ordinary income) at 4139:

- Was the incentive payment a profit or gain made by the firm from a transaction that formed part of the ordinary course of its business?
- Was the incentive payment a profit or gain made from a transaction that was not in itself part of the ordinary course of the taxpayer's business, but which was an ordinary incident of the business activity of the firm?
- If any profit or gain was made by the firm from an extraordinary transaction, was the profit or gain so made acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to a profit?

Importantly, this analysis of the above three principles of Myer was also followed by the High Court in *Montgomery* (1999) 198 CLR 639 at 672, 676, 677; 99 ATC 4749.

**Online Activity 10:** Read *FCT v Myer Emporium Ltd* (1987) 163 CLR 199

### 3. Capital receipts are generally not ordinary income

As a general principle capital receipts do not constitute ordinary income. Although the capital gains tax provisions may bring these receipts into the income tax base, the income/capital distinction remains important, as there are many pre-CGT assets (acquired before 20 September 1985) and other exemptions that cause capital receipts to be preferentially treated. For example, individuals are entitled to a 50% CGT discount on assets held longer than one year.

A periodical receipt indicates income (see Dixon) while a one-off lump sum indicates a capital receipt, although there are many instances where one-off lump sums have been held to be income. In *Myer Emporium* a lump sum payment in consideration for assigning its right to interest was held to be income. Also, in *Henry Jones v FCT* 91 ATC 4663 a lump sum payment received in consideration for the taxpayer assigning its rights to receive royalties was held to be income.

The capital v income cases can be categorised as follows:

- gains from the sale of property
- payments for restrictive covenants are generally not income
- gains which constitute compensation for an amount of income, have the character of income
- undissected lump sums must be apportionable.

#### ***Gains from the sale of property***

Gains from the sale of property can be classified into three types:

##### *Mere realisation*

If you are only selling to merely realise an asset so as to get its full value the courts have traditionally held that such a receipt does not constitute income. See *Scottish Australian Mining v FCT* (1950) 81 CLR 188; 9 ATD 135. *Casimaty v FCT* 97 ATC 5135.

Eg: Xen rents out an office for 10 years and then sells the office in the current tax year. This is not ordinary income, it is a mere realisation of an asset (no profit purpose when acquired).

##### *Realisation as a business venture*

If assets are realised as part of a business venture, the proceeds from the asset sales will constitute ordinary income. See *FCT v Whitfords Beach Pty Ltd* (1982) 150 CLR 355; 82 ATC 4031.

**Online Activity 11:** Read *FCT v Whitfords Beach Pty Ltd* (1982) 150 CLR 355

##### *Realisation as an extraordinary transaction*

A mere realisation of a capital asset is capital, but if there exists a profit-making intention at acquisition it will be income; as previously discussed in *Myer Emporium*. *Myer Emporium*, though, does not provide authority that all gains from property made by a business will be income: see *Westfield Ltd v FCT* (1991) 28 FCR 333.

**Online Activity 12:** Read *Myer Emporium*

### ***Payments for restrictive covenants are generally not income***

Restrictive covenants are agreements that restrict a person's future income-earning capacity, and are generally considered to be capital: see *Dickensen v FCT* (1958) 98 CLR 460, *FCT v Woite* 82 ATC 4578. Note that restrictive covenant payments are subject to CGT.

**Online Activity 13:** Read *Dickensen v FCT* (1958) 98 CLR 460

### ***Compensation payments***

Compensation payments can be classified into the following three categories.

#### ***Payments for loss of income and income-earning capacity***

Payments for loss of income and income-earning capacity will be income if they are made to compensate loss of income: see *FCT v DP Smith* (1981) 147 CLR 578, *Liftronic v FCT* 96 ATC 4425.

Although, if the compensation is for a capital item, then generally you will have a capital receipt: see *Atlas Tiles Ltd v Briers* 78 ATC 4536. In *Atlas Tiles*, the court held that income-earning capacity is a capital item and therefore an amount for a loss of earning capacity is a capital amount, and thus not income. See *Coward and FCT* 99 ATC 2166

**Online Activity 14:** Read *FCT v DP Smith* (1981) 147 CLR 578

#### ***Payments for the loss or sterilisation of capital assets***

Payments for the loss or sterilisation of capital assets are generally capital: see *Glenboig Union Fireclay Co Ltd v IRC* (1922) 12 TC 427

However, there must be a permanent deprivation, a payment for a temporary deprivation of an asset would constitute income. See *Burmah Steamship Co Ltd v IRC* (1930) 16 TC 67

#### ***Payments for cancellation or variation of business contracts***

The various types of payments can be classified into three types as follows: ordinary trading contracts, contracts relating to the structure of the business and contracts relating to business agencies.

##### *1. Ordinary trading contracts.*

Amounts received for the cancellation or variation of ordinary trading contracts are generally income: see *Heavy Minerals Pty Ltd v FCT* (1966) 115 CLR 512. Invariably these payments

will be made to compensate for the loss of profits that would have been made without the cancellation/variation.

Eg: Dave a plumber is contracted to work for Helen's hotel business for one week. But Dave can't do the work and Helen suffers a loss of hotel income. Dave pays Helen \$1,000 for her loss of income. This is ordinary income.

## 2. *Contracts relating to the structure of a business.*

If cancellation/variation substantially affects the structure of a business and is not a normal incident of the business, it is generally capital: see *Van Den Berghs Ltd v Clark* (1935) 19 TC 390

## 3. *Contracts relating to business agencies.*

If an agency is one of several and its cancellation is a normal incident of the business, then compensation received will generally be income: see *Allied Mills Industries Pty Ltd v FCT* 89 ATC 4365.

However, if the agency is the sole or main source of income for a business and cancellation/variation is not a normal incident its more likely to be capital: see *California Oil Products Ltd v FCT* (1934) 52 CLR 28.

Eg: Jing has an exclusive 20 year agency contract to sell widgets made by Yen. Yen's sole business is selling widgets to Jing. Jing stops selling these widgets and thus Yen goes out of business. Yen receives \$100,000 compensation from Jing, this is not ordinary income (agency is the sole source of income). Note CGT may apply.

**Online Activity 15:** Read *California Oil Products Ltd v FCT* (1934) 52 CLR 28.

### ***Undissected lump sums must be apportionable***

Undissected lump sum payments usually occur as a consequence of damages or out-of-court settlements. If the lump sum represents compensation for income, the amount will be income. However, where a taxpayer receives an amount which comprises partly an income component and partly a non-income sum the entire amount will be a capital sum if there is no basis for apportionment: see *McLaurin v FCT* (1961) 104 CLR 381. This provides authority that the full amount is not income. This view was confirmed in *Allsop v FCT* (1964) 113 CLR 341. Although, if it is not income, then the capital gains tax (CGT) provisions will need to be considered.

**Online Activity 16:** \$1,000 paid to an employee on 1 July of the current year for the previous fortnight's work. When is it derived?

**Online Activity 17:** Andy lent money to his brother, Bert. Formal documentation was drawn up and the loan was on a normal commercial basis. Interest on the loan though was paid to Andy by another brother, Hector. Is the interest that Andy receives assessable under section 6-5 of the ITAA 1997?

**Online Activity 18:** Peter is employed as a researcher. His research was published in scientific journals and discussed at conferences. A scientific organisation paid \$10,000 to Peter for a research prize. The purpose of the prize was to recognise, encourage and stimulate achievements. The prize also aims to entice young people to seek a career in particular industries. Candidates are not allowed to nominate themselves for this prize. Is this ordinary income?

**Online Activity 19:** Jane, is a fashion wholesaler and has three agency agreements with Ell, Chrissie and Nomie Fashions respectively. Due to the closure of Chrissie Fashions her ten year agency agreement is cancelled and Jane receives \$100,000 compensation as this constituted 60% of her business. Is this ordinary income?

**Online Activity 20:** Australian Tax 2013 Chapter 4 Practice Problems 1-4; Chapter 5 Practice Problems 1-10