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A. Introduction to Tax Policy

i. Why do we need taxes?

"Tax is the price of civilization" (Wendall Holmes)

Justifications for taxation:

- The cost of government is large. In the 2016/16 Budget, Commonwealth Government expenditure was estimated at approximately $431bn for the following year.
- Tax is the main method via which our government raises revenue, and accounts for approximately 95% of Australian Government revenue.
- In essence, we pay taxes so the government can support society.
- Benefit theory of taxation:
    - The benefit theory of taxation says we pay taxes in order to fund public goods (public good being those goods and services that either will not be supplied by the market or will be supplied by the market but in insufficient quantity.
    - Public goods have two critical properties:
        - 1. It costs nothing for an additional individual to enjoy their benefits; and
        - 2. They are non-excludable i.e. it is not possible to exclude anyone from their benefit.
            - E.g. National defence, public health and education.
- Redistribution justification:
    - We raise taxes to fund redistribution so as to address economic inequality and poverty.
    - In AUS, more than 1/3 of Cth government expenditures are on social security and welfare payments

Justification for income tax specifically:

- The focus of this course is income tax, which is Australia's most important tax.
- Income tax on individuals, companies and other entities generates about 70% of Commonwealth tax receipts, and about 60% of all tax revenues in Australia.
- The income tax has been seen by many as an ideal tax for funding public goods and to achieve the goal of redistribution because payment is based on ability to pay and its rates can be (and almost inevitably are) progressive, so that those with more income pay more in taxes.
    - NB this point was emphasized by Attorney General Billy Hughes in his second reading speech on introducing the federal income tax in Australia in 1915.

Alternative mechanisms of revenue raising

- Note that governments can, in theory, finance themselves by a variety of means, including:
    - Commandeering resources from private individuals;
    - Creating money;
    - Borrowing money;
    - Government enterprise e.g. Middle Eastern governments controlling and selling oil resources to fund government; or
    - Taxation.
- Benefit of taxation over other methods:
    - Adam Smith said that only taxes can provide "that sure, steady, and permanent revenue which can alone give security and dignity to government…defraying the necessary expense of any great and civilized state" (1776)
    - If done properly, tax is also the least disruptive to the economy → doesn't involve government intervention in controlling market resources etc. MB says that in an ideal world, taxation shouldn't affect economic decision making.

ii. Tax Base

- A 'tax base' refers to *what* you're actually taxing i.e. *what is the basis upon which the government determines how much each taxpayer must pay?*
- The 3 major tax bases available to government in modern times are:
    - 1. Income;
    - 2. Consumption; and
    - 3. Wealth
- The ethos that guides the choosing of a tax base is that people should pay what they are able to

  - i.e. if we tax people's wealth or consumption, the more wealth they have or the more they consume should reflect their ability to pay more tax.
- No developed economy relies on a *single* tax to raise government revenue. The combination of taxes used is sometimes called the "tax mix".
- NB that there is also this thing called a 'head tax', which means "if you have a head, you pay the tax" i.e. each person pays it, regardless of income, consumption or wealth.
- In Australia however, we rely heavily on *income tax*.
- Yet NB the close link between income, consumption, and wealth:

Income = Consumption + ▲ wealth (savings)

  - ➢ Your income for the year will be equal to your total spending (consumption) + your total savings (wealth)
  - ➢ Idea is that because of this relationship, taxing your consumption or savings (wealth) is the same as taxing your income.
  - ➢ However, NB in AUS the focus on income.

Focus of this course: a) what is included in your taxable income, and b) what is deductible from your taxable income?

iii. Evaluating a Tax System: Equity, Efficiency, Simplicity

In Australia, it is generally agreed that the criteria against which to evaluate tax policy are equity, efficiency, and simplicity.

Equity

- Equity = fairness
- Seen as having two dimensions → horizontal equity, and vertical equity
  - Horizontal equity means that taxpayers in like situations should be treated alike
  - Vertical equity means that taxpayers in different positions should pay appropriately different amounts of taxes i.e. those with a greater ability to pay tax should pay more.
    - NB vertical equity is the basis for progressive tax systems.

Efficiency

- It is widely accepted that a tax should be as 'efficient' as possible
- Interpreted as saying that taxes should not influence individual choices (neutrality)
- Again, idea that market efficiency should not be impeded by the collection of taxes → tax should not factor into our economic decision making.
- Relevant concepts include:
  - Neutrality: gold standard for a tax system; i.e. where tax doesn't affect economic behaviour.
  - Elasticity: this is a measure of neutrality i.e. how much does a tax or change in taxation rates affect behaviour e.g. a tax on lifesaving medication would have an inelastic neutrality because higher taxes won't put off people who need it buying it.
  - Incidence vs. Burden: Incidence refers to the person/entity that the tax is technically put on i.e. who has to send the cheque to the ATO (e.g. a company or business) but the burden of the tax refers to who actually feels the impact of the tax burden e.g. maybe company passes on the tax burden to their employees through pay cuts, or customers through price increases.
  - Deadweight loss: deadweight loss refers to a cost to society created by market inefficiency. In this instance, when you tax a behaviour and people stop engaging in the behaviour, the loss is the enjoyment of that behaviour by society.

Simplicity

- The tax system is almost universally decried as prohibitively complex.
- The goal of simplicity means that taxes should be collected with the minimum cost of administration by government or of compliance by taxpayers.
- Seems to always be a trade-off between equity/efficiency and simplicity, because generally the more technical and economically efficient we want to be, the more complex we have to be in how we deal with people.

Applying the criteria: implementation of tax policy

- When governments apply tax policy, they are generally dealing with conflict between the above objectives → often controversy surrounding taxation law decisions.
- However, there has been broad agreement over many years on the general direction of tax reform in Australia – that is, broadening the base of taxes (i.e. more things attracting tax) and lowering tax rates.
  - General idea was that if all income or expenditure was taxed without exclusions or concessions, that produced horizontal equity as well as efficiency and simplicity.
  - In turn, lower tax rates would then produce the same revenue and interfere less with individual choices, contributing to efficiency.

- Further, progressive tax rates could be retained to the extent it was desired to differentiate between taxpayers and ensure those with more income paid higher income tax, thus achieving vertical equity.

- There have been several major reviews of the tax system since the 1970s (see p.6 in textbook for more information)
    - 1975: Asprey Report – never came to fruition because of dismissal of Whitlam government, but proposed a GST (called a 'value added tax – VAT in the report), as well as a capital gains tax and reform of the taxation of foreign income.
    - 1985: Hawke Labor Government embarked on major tax reform which gave us the fringe benefits tax, CGT, and the imputation system.
    - 1990s: The Liberal/National Coalition led by John Hewson in opposition proposed major tax reform including a broad based GST and lowering income tax rates. In 1996, Libs won government under John Howard, who then introduced GST in 1999 at a rate of 10%, with all revenues going to the states. Income tax rates were lowered and family welfare benefits were significantly increased.

iv. Australia's progressive income tax rate scale

Tax rates 2016–17

The following rates for 2016–17 apply from 1 July 2016.

Taxable income	Tax on this income
0 – $18,200	Nil
$18,201 – $37,000	19c for each $1 over $18,200
$37,001 – $87,000	$3,572 plus 32.5c for each $1 over $37,000
$87,001 – $180,000	$19,822 plus 37c for each $1 over $87,000
$180,001 and over	$54,232 plus 45c for each $1 over $180,000

The above rates **do not** include the:

- Medicare levy of 2%
- Temporary Budget Repair Levy; this levy is payable at a rate of 2% for taxable incomes over $180,000.

- Above are the *marginal income tax rates*. I.e. they reflect the rate you pay on your next $ or unit.
- Marginal rates for 2016/17 are 0%, 19%, 32.5%, 37%, and 45% (as above).
- Your *effective tax rate* will be different to your marginal rate → calculate after you know how much tax you're paying total out of your total income.
- NB the rates above don't include the Medicare levy or the temporary budget repair levy (as indicated in the graph).
    - MB: make it clear in your answers whether you're including Medicare and budget repair levy in your final answer or not.

B. The Australian Taxation System

i. The Structure of Australian Income Tax Law

Taxation and the Cth Constitution

- When considering the creation of tax legislation and the statutes above, recall the constitutional background to taxation laws contained in the Commonwealth Constitution.
- **S51(ii)** gives the Commonwealth power to make tax laws, but not so as to discriminate between the states.
    - Recall from Fed Con: *Roy Morgan Research Pty Ltd v Commissioner of Taxation & Anor* [2011] HCA 35: A tax is "a compulsory exaction of money by a public authority for public purposes, enforceable by law." [cf. a fee for service; cf. a penalty]
- **S55:** 'Laws imposing taxation shall deal only with the imposition of taxation, and any provision therein dealing with any other matter shall be of no effect.'
    - This is why the laws imposing the tax are set out separately to the ones dealing with how to apply the tax.

Australian Income Tax Statutes

- Income Tax Act 1986: Sets out *what taxes* we have in Australia.
- Income Tax Assessment Act 1936: 1 of the 2 main Acts we deal with that tells us *how to apply* the taxes.
    - Provisions of the '36 Act are phrased "s26A" "s13B" etc.
- Income Tax Assessment Act 1997: 2 of the 2 main Acts we deal with telling us *how to apply* taxes.
    - Provisions of the '97 Act are phrased "s15-2", "s14-3" etc.
        - NB it is a quirk of history that we have these two operative statutes telling us how to apply taxes
        - Reason being that a change of government meant the 1997 Act was never finished – now works in conjunction with '36 Act.
        - The '97 Act explicitly says that cases interpreting identical provisions in the '36 Act still apply.
- Income Tax Rates Act 1986: Tells us what the tax rates are
- Fringe Benefits Tax Act 1986: Implements Fringe Benefits Tax
- Fringe Benefits Tax Assessment Act 1986: Tells us how to assess/apply FBT

Basics of the Australian Income Tax System

1 Charging Provision – who is liable?

***ITAA (1997)*, s4-1**
Who must pay income tax
Income tax is payable by each individual and company, and by some other entities.
The actual amount of income tax payable may be nil.
For a list of the entities that must pay income tax, see Division 9, starting at section 9-1.

***ITAA (1997)*, Division 9 – 'Entities that must pay income tax'**
s9-1 List of entities
Income tax is payable by the entities listed in the table:

1. An individual;
2. A company that is a body corporate; or an unincorporated body (except a partnership)
3. A company that was a member of a wholly-owned group if a former subsidiary in the group is treated as having disposed of leased plant and does not pay all of the income tax resulting from that treatment;
4. A superannuation provider in relating to a complying superannuation fund;
5. A superannuation provider in relation to a non-complying superannuation fund
6. A superannuation provider in relating to a complying approved deposit fund
7. A superannuation provider in relation to a non-complying approved deposit fund
8. The trustee of a pooled superannuation trust
9. A corporate limited partnership
10. A mutual assurance association
11. A trustee, but only in respect of some kinds of income of the trust
12. The trustee of a public trading trust

2 Tax Period

***ITAA (1997)*, s4-10(1)**
How to work out how much income tax you must pay
(1) You must pay income tax for each financial year.

- NB 'financial year' is defined in s995-1 'definitions' as meaning *a period of 12 months beginning on 1 July* [to 30 June].

ii. How do we calculate the amount of tax payable?

S4-10(3) tells us how we calculate total income tax payable. NB that much of this course is focused on determining what goes into the 'taxable income' portion of this calculation.

S4-10(3), *ITAA* '97: **Income Tax = (Taxable Income x Rate) – Tax Offsets**

***ITAA (1997)*, s4-10(3)**
(3) work out your income tax for the financial year as follows:

Income Tax = (Taxable Income x Rate) – Tax Offsets

Method Statement:

- Step 1: Work out your taxable income for the income year. [TO do this see s4-15 → will be a lengthy step]
- Step 2: Work out your basic income tax liability on your taxable income using:
  - (a) the income tax rate or rates that apply to you for the income year; and
  - (b) any special provisions that apply to working out that liability
    [For rates see *Income Tax Rates Act 1986* and s4-25]
- Step 3: Work out your tax offsets for the income year. A tax offset reduces the amount of income tax you have to pay. [For the list of tax offsets, see s13-1].
- Step 4: Subtract your tax offsets from your basic income tax liability. The result is how much income tax you owe for the financial year.

iv. How do we determine taxable income?

You can see above that the important first step in determining income tax payable is totaling up your *taxable income*. We determine taxable income by looking to s4-15 of the *ITAA 1997*.

S4-15, *ITAA* '97: **Taxable Income = Assessable Income - Deductions**

***ITAA (1997)*, s4-15(1)**
(1) Work out your ***taxable income*** for the income year like this:

Taxable Income = Assessable Income – Deductions

Method Statement:

- Step 1: Add up all your assessable income for the income year
  [To find out about your assessable income, see Division 6]
- Step 2: Add up your deductions for the income year
  [To find out what you can deduct, see Division 8]
- Step 3: Subtract your deductions from your assessable income (unless they exceed it). The result is your taxable income. (If the deductions equal or exceed the assessable income, you don't have taxable income).

  NB: If the deductions do exceed the assessable income, you may have a tax loss which you may be able to utilise in that or a later income year: see Division 36.

NB Tax Offsets vs. Tax Deductions

- Tax offsets and tax deductions are *not the same thing*.
- Note from the formulas above that a tax deduction is something you *deduct from your taxable income* before calculating the amount of tax you pay, whereas a tax offset is *subtracted from your income tax* *liability* *at the end*.

iv. Types of income under the *ITAA*

Ordinary Income

- Refers to income according to 'ordinary concepts' i.e. according to judicially developed concepts
- Most income comes into assessable income as ordinary income as bulk of ordinary income is rent, wages etc. which are all ordinary income

***ITAA (1997)*, s6-5**
Income according to ordinary concepts (ordinary income)

(1) Your ***assessable income*** includes income according to ordinary concepts, which is called ***ordinary income***.
[Note: some of the provisions about assessable income listed in s10-5 may affect the treatment of ordinary income.]

(2) If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year.

(3) If you are a foreign resident, your assessable income includes:

(a) the ordinary income you derived directly or indirectly from all Australian sources during the income year; and

(b) other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source.

(4) In working out whether you have ***derived*** an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct.

Statute Summary:

- Ordinary income for AUS residents is any income you derive, whether from in AUS or from overseas.
- Ordinary income for non-residents only includes income sourced in Australia.
- NB subsection (4) → you 'derive' income as soon as it is applied or dealt with by you *or on your behalf* i.e. putting your salary in your wife's bank account = her dealing with it 'on your behalf'; doesn't become 'her income'.

Statutory Income

- Although the judicial concept of income has moved over time in Australia, the speed of change has been too slow for the legislature, which has intervened increasingly from the 1980s to correct perceived aberrations in the law.
- Until 1985, much of the legislative intervention was simple repair of the law, but since then the interventions have changed the face of Australian income tax law so as to reduce greatly the practical significant of the concept of ordinary income in the sense that many gains falling outside ordinary income are now usually subject to tax.
- Although the changes have been many, two stand out: the capital gains tax and the fringe benefits tax.

***ITAA (1997)*, s6-10**
Other assessable income (statutory income)

(1) Your assessable income also includes some amounts that are *not* ordinary income.

[Note: These are included by provisions about assessable income. For a summary list of these provisions, see 10-5].

(2) Amounts that are *not* ordinary income, but are included in your assessable income by provisions about assessable income, are called ***statutory income***.

[Note 1: Although an amount is statutory income because it has been included in assessable income under a provision of this Act, it may be made exempt income or non-assessable non-exempt income under another provision: see s6-20 and 6-23.]

[Note 2: Many provision in the summary list in s10-5 contain rules about ordinary income. These rules do not change its character as ordinary income.]

(3) If an amount would be statutory income apart from the fact that you have not received it, it becomes statutory income as soon as it is applied or dealt with in any way on your behalf or as you direct.

(4) If you are an Australian resident, your assessable income includes your statutory income from all sources, whether in or out of Australia.

(5) If you are a foreign resident, your assessable income includes:

(a) Your statutory income from all Australian sources; and

(b) Other statutory income that a provision includes in your assessable income on some basis other than having an Australian source.

Not-Assessable Income

- Not-assessable income is defined as anything that is neither ordinary or statutory income.

***ITAA (1997)*, s6-15**
What is not assessable income

(1) If an amount is *not* ordinary income, and is *not* statutory income, it is not ***assessable income*** (so you do not have to pay income tax on it).

(2) If an amount is exempt income, it is not assessable income.

[Note: If an amount is exempt income, there are other consequences besides it being exempt from income tax. For example:
- The amount may be taken into account in working out the amount of a tax loss (see s36-10);
- You cannot deduct as a general deduction a loss or outgoing incurred in deriving the amount (see Division 8);
- Capital gains and losses on assets used solely to produce exempt income are disregard (see s118-12).]

(3) If an amount is non-assessable, non-exempt income, it is *not* assessable income.

[Note 1: You cannot deduct as a general deduction a loss or outgoing incurred in deriving an amount of non-assessable non-exempt income (see Division 8)].

[Note 2: capital gains and losses on assets used to produce *some* types of non-assessable non-exempt income are disregarded (see s118-12].

Exempt Income
- Exempt income you do not have to pay income tax on either.
- So Non-assessable, exempt income = no tax.

***ITAA (1997)*, s6-20**
Exempt Income

(1) An amount of ordinary income or statutory income is exempt income if it is made exempt from income tax by a provision of this Act or another Commonwealth law.

For summary lists of provisions about exempt income, see ss11-5 and 11-15.

(2) Ordinary income is also exempt income to the extent that this Act excludes it (expressly or by implication) from being assessable income.

(3) By contrast, an amount of statutory income is exempt income only if it is made exempt from income tax by a provision of this Act outside this Division or another Commonwealth law.

(4) If an amount of ordinary income or statutory income is non-assessable non-exempt income, it is *not* exempt income.

Note: an amount of non-assessable, non-exempt income is not taken into account in working out the amount of a tax loss.

***ITAA (1997)*, s11-5**
Entities that are exempt, no matter what kind of ordinary or statutory income they have
- Charity, education, or science educational institution, public (50-5)
- Registered charity (50-5)
- Scientific institution (50-5)
- Scientific research fund (50-5)
- Scientific society etc. (50-5)
- Employee association (50-15)
- Employer association (50-15)
- Trade union (50-15)
- Local governing body (5025)
- Art society etc. (50-45)
- Game society (50-45)

… [and more]

e) Non-Assessable Non-Exempt Income (NANE)

- Both non-assessable *exempt* income and non-assessable *non-exempt* income are not assessable.
- However, exempt income can be used to soak up tax losses i.e. if you have $100 tax loss, but $50 of exempt income, that $50 of exempt income will be offset against $50 of your tax loss, so you only get the benefit of half your tax loss.

- By comparison, NANE income is not assessable AND not exempt, so it has no relationship to your deductions i.e. does not soak up your tax losses.

> ***ITAA (1997)*, s6-23**
> Non-assessable non-exempt income
> An amount of ordinary income or statutory income is non-assessable non-exempt income if a provision of this Act or of another Commonwealth law states that it is not assessable income and is not exempt income.
>
> Note: capital gains and losses on assets used to produce *some* types of non-assessable non-exempt income are disregarded (see s118-12).
>
> For a summary list of provision about NANE income, see subdivision 11-B.

Relationship

- 1. If the same income is captured by more than one provision about assessable income, the amount is included only once in your assessable income for an income year and not in another year either.
- 2. Statutory income prevails over rules of ordinary income.

> ***ITAA (1997)*, s6-25**
> Relationships among various rules about ordinary income
> (1) Sometimes more than one rule includes an amount in your assessable income:
> - the same amount may be ordinary income and may also be included in your assessable income by one or more provisions about assessable income; [i.e. ordinary + statutory] or
> - the same amount may be included in your assessable income by more than one provision about assessable income [i.e. in two categories of statutory income].
>
>   However, the amount is included only once in your assessable income for an income year, and is then not included in your assessable income for any other income year.
>
> (2) Unless the contrary intention appears, the provisions of this Act (outside this Part) prevail over the rules about ordinary income.
>
> Note: This Act contains some specific provisions about how far the rules about ordinary income prevail over the other provisions of this Act.

Ordinary Income

Ordinary Concepts of Income

A. Parson's Propositions on Income

Propositions dealing with when and how much income is derived

Proposition 1:	An item of an income character is derived when it has "come home" to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation.
Proposition 2:	An item of an income character that has been derived will be income in the amount of its realizable value.
Proposition 3:	The character of an item as income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it would have had if it had been derived by another person.

Propositions dealing with who derives income

Proposition 4:	To have the character of income an item must be a gain by the taxpayer who derived it.
Proposition 5:	There is no gain unless an item is derived by the taxpayer beneficially.
Proposition 6:	There is no gain if an item is derived by the taxpayer from himself: the principle of mutuality.

Propositions defining the concept of income according to ordinary concepts

Proposition 7:	There is no gain if an item is derived by the taxpayer as a contribution to capital.
Proposition 8:	A gain which is a mere gift does not have the character of income.
Proposition 9:	A mere windfall gain does not have the character of income.
Proposition 10:	A capital gain does not have the character of income.
Proposition 11:	A gain which is one of a number derived periodically has the character of income.
Proposition 12:	A gain derived from property has the character of income.
Proposition 13:	A gain which is a reward for services rendered or to be rendered has the character of income.
Proposition 14:	A gain which arises from an act done in carrying on a business, or from the carrying out of an isolated business venture, has the character of income.
Proposition 15:	A gain which is compensation for an item that would have had the character of income had it been derived, or for an item that has the character of a cost of deriving income, has itself the character of income.

B. Introduction to the Concept of Ordinary Income

i. What are the sources of our concept of "ordinary income"?

1. References in the Legislation

- As you can see above, the ITAA 1997 s6-5 covers "income according to ordinary concepts which is called ordinary income."
  - However, the legislation offers little guidance on what is "ordinary income"
  - Thus, we have to turn to case law for assistance.
    - NB that s6-10 adds that your assessable income also includes amounts covered by other sections that aren't ordinary income, which are called 'statutory income'. So, for income tax law, the meaning of income thus comes from two sources: the opinions of judges, and the elaborations in the ITAAs

2. Starting Point in the Case Law

- Despite the large accretions to the income tax legislation in recent years, most income which is taxed in AUS enters the statutory calculation as income according to ordinary concepts, that is, what the judges say is income in case law.
- Judges are hesitant to depart from previous judgements re: tax, or to make new declarations about what is/isn't income.
- When making general statements about the law on the meaning of income for income tax purposes, many judges content themselves with a repetition of the words of Jordan CJ in *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215:

> "*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.*"

    - On the basis of this passage, the judicial elaboration of 'income' was often referred to as the "ordinary concepts" notion of income.
    - This label was simply appropriated by the drafter + given statutory force in s6-5 of *ITAA '97*.

- In deciding particular cases, the judges rely on decided cases with similar facts and apply or distinguish them in the normal common law way.
- It has been largely left to text writers to try to classify these cases and see what common ideas arise.
- There is general agreement in dividing the judicial concept of income into 3 broad areas:
    - **1. Income from services;**
    - **2. Income from business; and**
    - **3. Income from property.**

Although Australian judges have created most of the law on what constitutes income for Australian income tax purposes, they have not worked in a vacuum, for concepts of income were available in other areas of the law and in overseas jurisdictions. See below.

3. Influence of Trust Law

- Trust law has, for many centuries, had to elaborate a meaning for income to divide trust property among beneficiaries with differing right sin the trust.
- Trust concepts of income have been influential in developing the tax law concept of income.
    - E.g. the income capital distinction:
        - the failure of judges to include capital gains in their concept of income can be attributed to trust law → in trust law, the division of property between beneficiaries is usually effected by the income-capital distinction in that there will be income beneficiaries and capital beneficiaries of the trust. For instance, if property is left by a will on trust to the spouse of the dead husband for life and the remainder to the children of the deceased after the death of the spouse, the spouse will be entitled to the income from the property for life, and then the property will pass to the capital beneficiaries (the children) on the spouse's death.

4. Economists' notion of income

- The economist's notion of income is that income is the *gain* to the taxpayer during the relevant period.
    - At face value, the economic literature gives us a far more comprehensive definition of income than the judicial concept of income does.
- However, the judicial concept of ordinary income is both under-inclusive and over-inclusive when compared with the economic definition:
    - On the one hand, it is under-inclusive because it doesn't generally include gifts, and gambling and lottery winnings, nor as discussed above capital gains.
    - On the other, the judicial definition of ordinary income includes the gross amount of annuities and royalties paid to a person even though the payments include some recovery of the purchase price or property involved in the transaction and do not represent pure gain. Also NB the 'defective valuation' principles discussed at p.41 in textbook.

5. UK Doctrine of 'source'

- UK doctrine of 'source' describes income as a *flow* which is linked to a *source* of income.
    - This is the idea that 'income' is a fruit that comes from a tree → we tax only the fruit and not the tree, i.e. the rent from a property is income, not the property itself.

C. Realizations: Income as a 'Flow'

i. PP1 → "Come Home" Requirement

PP1: An item of an income character is derived when it has "come home" to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation.

- The idea here is that income must not just be a 'possibility' or an 'eventuality', but actually have *come home* to the taxpayer i.e. just because you own a house with rental potential of $250 doesn't mean you're getting that income if you don't choose to let it out.
    - Consider the liquidity issues → just because you have potential for income doesn't mean you have that income to use, and unless you have that income to use you can't be forced to meet taxation obligations.
        - In other words, what are you going to pay the tax with if there's a gain but it hasn't yet been made manifest?

          Lord Denning in *Abbott v Philbin* [1961] AC 352 at 384:
          "*A bird in the bush is not taxable, even if you have the right to get it in the future, if it is still there. You must have it in your hand before you can be taxed for it.*"

- An example of the 'realisation' ('income as flow') requirement is that tax is not collected from the owner of a share in a company which has just earned substantial profits until either the profits are distributed to the shareholder as dividends or the shareholder sells the shares and collects the value of the profits from the purchaser.
    - In other words, the requirement of realisation before an amount can be defined to be income postpones the time at which accretions to economic power are taxed until the time when the appropriate event "releasing" the gain occurs.

- Further, whatever 'flows' to you or 'comes home' to you is income, whether or not that be from some illegal or immoral source.

ii. PP4 → "Gain" Requirement

PP4: To have the character of income an item must be a gain by the taxpayer who derived it.

- ***Hochstrasser v Mayes* [1960] AC 376:**
    - <u>Facts:</u> Employer reimbursed their employee for the employee's loss arising from the sale of their house, which they had to sell only due to a job transfer.
    - <u>Issue:</u> Was this reimbursement for the loss income or not?
    - <u>Held:</u> not income: "I regard this as a plain case. No one, coming fresh to it, untrammelled by cases, could regard this 350 pounds as a profit from the employment."
    - <u>Reasoning:</u>
        - Mr Mayes did not make a profit on the resale of the house, he made a loss. And even if he had made a profit, it would not have been taxable [NB according to ordinary concepts]. "How then, can his loss be taxable, simply because he has been indemnified against it?"
        - The argument put by the other side was that if an employer, by way of reward for services, agrees to indemnify his employee against his losses on the Stock Exchange for example, the payments which the employee received under the indemnity would be taxable. BUT that would be because the losses were his own affair and nothing to do with his employment: the payments of indemnity would therefore be a straight reward for service.
        - However, this payment of 350 pounds was "nothing of that kind". It was a loss which Mr M incurred in consequence of his employment and his employers indemnified him against it.
        - "If Mr Mayes had been injured at work and received money compensation for his injuries, no one would suggest that it was a profit from his employment. Nor so here, where all he receives is compensation for his loss."
        - "the question simply is: was this 350 pounds received by Mr M a "Profit" from his employment? I think not, for the simple reason that it was not a remuneration or reward or return for his services in any sense of the word."
            - NB: the above is the 'ordinary concept' – the fringe benefits tax and capital gains tax may now affect the outcome in both the case and analogous situations (though not always clearly so).

iii. PP5: Beneficial Entitlement Requirement

PP5: There is no gain unless an item is derived by the taxpayer beneficially.

- ***The Countess of Bective v FCT* (1932) 47 CLR 417**
  - In this case, the Countess of Bective received trust money to be used for the maintenance and education of a child
  - Issue was – there is a flow, but is there a gain?
  - Held that there was no gain → to be a gain, the amount must be derived *beneficially*. As Countess was trustee, and therefore legal owner but not beneficial owner of the monies, she had no income.
  - In other words, a trustee obliged to distribute property doesn't receive "income" because they receive no beneficial entitlement to the money.

D. Identifying the Taxpayer and the Taxable Event

i. How do we identify the correct taxpayer?

- Although the correct taxpayer is usually self-evident, the ATO found in *Federal Coke Co Pty Ltd v FCT* that the self-evident taxpayer is not always the correct taxpayer.
- *Federal Coke* gives rise to PP3: the character of an item as income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it *would have had* if it had been derived by another person.

Federal Coke Co Pty Ltd v FCT (1977) 7 ATR 519:
  - Facts: Bellambi was a coal mining company and the parent of coke-producing subsidiaries, one of which was Federal Coke. The arrangement between the companies was for B to supply coal to Federal Coke, who would convert it to coke for a fee. In April 1970, B contracted to supply coke to Le Nickel SA, a French nickel processing company. Le Nickel then sought to vary their contract, so agreed to pay $1m to B for the variation in two equal instalments. The second instalment was paid to Federal Coke rather than B as consideration for the closure of FC's coking works which was necessitated by the change to the contract between B and Le Nickel.
  - Issue: Was the payment 'income' to Federal Coke? ATO tried to argue that if the sums had been received by B, they would have been assessable and therefore they were equally assessable to Federal Coke.
  - Held: The second instalment was *not* income, but compensation when paid to FC, because it was in recognition of the fact that the variation required FC to close their operations.
  - Reasoning (Bowen CJ):
    - Question for the commissioner is not what would have been the character of the receipts in the hands of Bellambi, but what, for the purposes of income tax is the character of the receipts in the hands of FC
    - Counsel for ATO argued that the payments were to compensate B for loss of profits, and for this reason they acquired an income character, and they retained this character and did not lose it when the payments were instead made to Federal.
    - HOWEVER, under a deed made 22 March 172, the payments were not received by Bellambi but rather FC.
    - A consequence of this is that one of the factors which would have impressed them with the character of income disappears. One is left only with the method of formulation and the original purpose of Bellambi and Le Nickel.
    - It appears to me that this is insufficient to impress upon the sum an essential and unchangeable character of income.
    - "Indeed, it appears to me that the starting point of this argument for the Commissioner is wrong. When one is considering the character of an amount received by a taxpayer, the inquiry must start with the question: what is the character of the receipt *in the hands of the taxpayer?*"
    - "It appears to me to be wrong to ask: what would have been the character of the amounts had they been received by Bellambi? And then to pose the question: has their character been changed by the fact that they were paid to Federal Coke? On must, I think, pose the essential question and start from that question: what is the nature of the receipts in the hands of Federal?"
    - "It then becomes less than decisive to observe that, in their origin, and if they had been received by B, they may have been of an income character. Each receipt in the hands of Federal is broadly in the nature of a gift, being a sum received without consideration."
    - Judge went on to hold that the gift was not assessable to Federal Coke.

ii. The Doctrine of Constructive Receipt

- The result in *Federal Coke* may suggest that virtually all taxpayers may be able to avoid income tax simply by directing payment of the income to a related party.
  - E.g. all wage earners could direct their employer to pay their wages to their spouse or their mortgage.

- However, the case left open the question of whether Bellambi was taxable on the payment. I.e. ***Federal Coke* didn't have to pay tax on the money it received on behalf of B from Le Nickel, but *would B have to pay tax on that amount?***
  - Short answer = yes. See below – doctrine of constructive receipt.

Doctrine of Constructive Receipt

- S6-5(4) of the ITAA 1997 (formerly s19 of the ITAA 1936) gives us the doctrine of constructive receipt, which is directed towards that kind of situation which was left unanswered in *Federal Coke*.

***ITAA (1997)*, s6-5(4)** Income according to ordinary concepts (ordinary income) … (4) In working out whether you have derived an amount of * ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct.

- Under the constructive receipt concept, a payment received by one party is treated as having been first (constructively) received by another party and then paid over to the actual recipient.
  - Indeed, as Bellambi was a business taxpayer it presumably was accounting for tax purposes on an earnings basis and so the full $1m could be treated as having been derived by Bellambi when it entered into the original agreement with Le Nickel.
- In order to prevent the income tax being subverted by payments directed in all manners to other parties, it would seem that a very extensive doctrine of constructive receipt is necessary; however, there is surprisingly little authority for it.

iii. Is it income at this time?

- Even where the taxpayer, and the basis on which the taxpayer is accounting are clear, there may be a question of the appropriate *event* to treat as a realisation, and whether the necessary income characteristics are present at that time.
- The answer is that the income characteristics of a particular event *must be assessed at the time when a derivation of income is claimed*.
- In this case of multiple stages or steps, there may be a question of which stage involves income derivation.
- This type of problem was typified by *Constable v FCT* → employer contributions to employee super-fund. When employee got pay-outs from super fund years later, it was pursuant to contractual right with super fund at that time, and not as income for services rendered from employer.

***Constable v FCT* (1952) 86 CLR 402**
- Facts: Employee contributes part of salary to super fund – vested and recoverable. Employer (Shell Company of Australia Ltd) also makes contributions – subject to exercise of discretion and vesting. There is then an accumulation of earnings in the fund, and employee receives payouts from super fund years later.
- Issue: Did the employee derive income when the employer contributions and the earnings were paid out? Commissioner tried to argue that all the money the employee got out of the fund was compensation for services and so was taxable. Employee argued he'd already been paid for his services, and that the money paid out was instead a contract between employee and the superfund.
- Held: Court agreed with employee and held that the money he got out of the fund was pursuant to a contractual right with the super fund and not income for services from employer.
- Reasoning:
  - ITAA 1936 s26(e) provides that the assessable income of a taxpayer shall include the value to him of all allowances, gratuities, compensation, benefits bonuses and premiums allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him, whether so allowed, given or granted in money, gods, land, meals sustenance, in the use of premises or quarter or otherwise…
  - **Majority (Dixon CJ, McTiernan, Williams and Fullagar JJ)**
    - Focus is can the sum, when received by the taxpayer from the super fund, or any part of it, be described as an allowance, gratuity, compensation, benefit, bonus or premium.
    - Further, if so, can it be said that it was "allowed, given, or granted to him" during that taxable year?
    - If an affirmative answer is given to these two questions, then is it correct to say of the amount or any part of it that it was so allowed, given or granted to him "in respect of, or for or in relation directly or indirectly, to any employment of him or services rendered by him"
    - In this case, the employment or services must be employment by, or services rendered to, the Shell Company of Australia Ltd.
    - On the facts, majority found that the payment could not correctly be said to be an allowance allowed, given or granted to employer "during the year of income under assessment".

            - "The fund existed as one to a share in which he had a contractual, if not a proprietary, title."
        - All that occurred in the year of income with recept to the sum in question was that the future and contingent or conditional right became a right to present payment, and payment was made accordingly.
        - Obiter [employer contributions also were not income at time paid in]:
            - Not relevant to decide case, but also said it wasn't income when employer paid contributions into the super fund as they were given to the administrators of the fund and not the employee.
            - "It is only after the administrators have exercised their discretion that any moneys paid are reflects in the employee's account, and even then that does not mean that the member becomes presently entitled to the moneys credited to that account."
    - **Webb J** (also held that derivation was not-assessable, but differed in his view on the treatment of contributions to the fund at the time of contribution):
        - See p.51/52 in textbook. Webb J *did* think that employer contributions, at the time they were put into the super account, were = to remuneration of the employee. "Upon such payment into the fund they ceased to be the property of the company and the payment then endured for the benefit of the appellant."
- Principle:
    - If *Constable* is accepted at face value, it stands for a further fundamental proposition that income characteristics have to be judged at the time when a receipt is claimed to be taxable by the ATO.
    - In that case, there were 3 possible times to test: contribution, vesting, and cashing out. Relevant time is cashing-out.
    - The fact that at an earlier or later event it may have the relevant income characteristics is not to the point, just as it was not to the point in *Federal Coke* that the receipt may have had an income character in the hands of Bellambi.
    - Thus, on the reasoning of the majority in *Constable,* the fact that the employer contribution may have had an income character when paid into the fund did not matter, as it was not constructively received then by the employee, and when actually received by the employee it no longer had the necessary income characteristics.

E. Valuation

PP2: An item of an income character that has been derived will be income in the amount of its realizable value.

- Having identified the relevant taxpayer, and the relevant time of income derivation, it remains to assign a number of AUD to the amount of assessable income.
- If the income is a cash amount, the valuation problem would seem to solve itself, but if the income is in another form, then it is necessary to provide a valuation test.
- Several possibilities suggest themselves, including:
    - 1. The amount that the provider spent to provide the benefit;
    - 2. the amount that the recipient would have had to spend to acquire the benefit; or
    - 3. the market value of the benefit.

i. The Problem of Non-Convertible Benefits

Starting Point: s21

- s21 of the ITAA '36 seems to suggest that if some income is not in cash form, it should be assigned its market value.

> ***ITAA (1936)* s21**
> Where consideration not in cash
> (1) Where, upon any transaction any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given.
>
> (2) This section has effect subject to section 21A.

- However, in reality valuation is not so straightforward.
- First, s21 seems to assume things have a 'money value', which they often don't
- Second, the cases seem to ignore s21 in favour of an English judicial test deriving from *Tenant v Smith*, which held that for the purposes of the relevant Schedule of the UK tax legislation, income had to be **given in cash form** or **on the facts, convertible to cash.**

Common Law Position (UK):

***Tennant v Smith* [1892] AC 150**

- Facts: Taxpayer was a bank employee who as required as a condition of his employment to live in a flat above the bank, which was provided rent-free to him. He was specifically prohibited from subletting the fat, and would have to leave the flat when he left the bank's employment. Tax office argued that occupying the flat rent-free provided the taxpayer with 50 pounds of income and that this, combined with his salary, had the effect of putting the taxpayer's total income above an income threshold.
- Issue: Was the free accommodation provided to the employee, which wasn't convertible to cash, capable of being assigned a dollar value such that it could be taxed?
- Held: No
- Reasoning: No income derived since not convertible to cash. However, NB this case lays down the principle for 'ordinary income' and doesn't preclude this kind of stuff being captured through statute e.g. Fringe Benefits Tax which we study later.

ii. Non-convertible benefits - position in AUS

Common Law Position (AUS):

- The basic valuation test that is applied under the income tax is exemplified in *FCT v Cooke and Sherden*, which seems to favour common law position.
- It says that if a taxpayer receives a benefit which cannot be turned to pecuniary account, then she has not received income as that term is understood according to ordinary concepts and usages.

***FCT v Cooke and Sherden* (1980) 10 ATR 696**

- Facts: The taxpayers were engaged in selling home delivery soft drinks. The product, the areas to be covered, the trucks used, and generally the whole infrastructure of the operation was supplied by the soft drink manufacturers, but the taxpayers were able to choose their own times for canvassing in the designated areas and acted as independent contracts. The taxpayers were provided with "free" holidays under a holiday scheme operated by the soft drink manufacturers on the basis of satisfactory performance during the year. It was *not possible to take a cash payment in lieu of the holidays* and the tickets, accommodation, etc. could not be transferred or sold.
- Issue: The ATO sought to tax the taxpayers on the amounts paid by the soft drink manufacturers for the holidays taken by the taxpayers under the scheme. Issue = were the 'holidays' taxable?
- Held: The full federal court held that the **taxpayers were not taxable**.
- Reasoning (per Brennan, Deane and Toohey JJ):
  - Starting point: "Whether a receipt is to be treated as income or not is determined according to "the ordinary concepts and usages of mankind" …except where statute sweeps in particular receipts or amounts which would not ordinarily be taken to fall within the concept."
  - "The notion [under the Act] that the items of income are money or are to be reckoned as money, accords with the ordinary concepts of income as "what comes into the pocket" to adapt Lord Macnaghten's phrase in *Tennant v Smith*."
    - "That is not to say that income must be received as money; it is sufficient if what is received is in the form of money's worth…"
    - "Nor is it necessary that an item of income be paid over to the taxpayer; it is sufficient, according to ordinary concepts and usages, that it be dealt with on his behalf or as he directs, as s19 of the Act recognises."
  - **"If a taxpayer receives a benefit which cannot be turned to pecuniary account, he has not received income as that term is understood according to ordinary concepts and usages."**
    - Said if on the facts, the taxpayers could convert their holiday tickets to cash, then the taxpayers would have received something that could constitute 'income'. However in this case, the respondents could not have turned the benefits in fact received by them to pecuniary account.
    - It is immaterial that the respondents would have had to expend money themselves had they wished to provide holidays for themselves. If the receipt of an item saves a taxpayer from incurring expenditure, the saving is not income; income is what comes in, it is not what is saved from going out.
      - Conclusion: "The benefit not being convertible into money or money's worth, there was no receipt of income according to ordinary concepts, and the assessments are not supposed by s25(1)."

Legislative amendment to common law (Business Context Only)

- The decision in *Cooke and Sherden* was reversed some years later by s21A of the *ITAA 1936* in the business context, but the principle that it espouses remains the general principle.

***ITAA (1936)* s21A**
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 shall be disregarded.

(3) … (4) …
(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.

iii. The Interaction of Derivation and Value Considered

Share options given to employees as part of their salary raise both valuation and derivation issues. The problems are well displayed in *Abbott v Philbin*.

***Abbott v Philbin* [1961] AC 352 – p57/58 textbook**
- Facts: In 1954, Abbott paid 20 pounds for an option to purchase 2000 shares in the company which employed him. The option was exercisable at any time over the next 10 years at the price of 68s, 6d, which was the market price of the shares at the time the option was granted. By 1956, the value of the shares had risen to 82s and he exercised his option in respect of 250 shares, paying the agreed price of 68s 6s, and retaining the shares. The Revenue included 166 pounds in his assessable income in 1956, being the difference between the option price and the current market price.
- Issue: Tax Office assessed tax on difference between exercise price and market value at time of exercise.
- Held: House of Lords by a majority held expressly that no amount could be included as in come in 1956. Their Lordships also implied that any tax consequences arose only in 1954 when the option had been granted.
  - When Abbott exercised his option, that was his exercising his rights as an option holder.
  - This didn't count as income for services rendered.
  - Could only have taxed whatever income he received *at time of grant of option*. At time of grant, the market price of the share = the option price, so there was no gain/income to tax so no tax at all.

F. Apportionment between Income and Capital

- The final issue that may arise in deciding the income character of a receipt or of determining the amount of assessable income in a receipt is *apportionment*.
- Scenario: TP receives a lump sum payment in respect of a number of matters, some of which are income in nature and some which are capital.
- Issue: under what circumstances can that receipt be apportioned between income + capital so that the income part can be taxed?
- The leading authority on apportionment is *McLaurin v FCT*.

***McLaurin v FCT* (1961) 104 CLR 381**
- Facts: TP commenced action for damages resulting from a fire, which settled. Compensation given to them for loss of both revenue assets (income in nature) and capital assets (capital in nature).
- Issue: What part of compensation, if any, is income and thus taxable?
- Held: Not proper to apportion in these circumstances → entire payment was capital.
  - "In a proper case a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates an income or non-income nature attributed to portions of it accordingly. It cannot be appropriate where the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single undissected amount of damages. In such a case, the amount must be considered as a whole." I.e. if the receipt cannot be apportioned between income and capital, the whole amount is treated as capital.

1. Income from Property

- "Income from Property" is one of the 5 categories of ordinary income. It must be distinguished from the *use* of property for gains on the realisation of property's value (i.e. CGT). Receipts for use give rise to ordinary income. Receipts for realisation give rise to CGT.

- The goal of this part of the seminar is identifying the tests employed to determine whether a receipt is to be characterised as income from the use of property or a capital receipt, such as the proceeds on disposal of property. Then, once the receipt has been characterised, we can determine the tax consequences.

- In this context, we consider three types of income from property: interest, rent and royalties i.e. making money from the severed 'fruit' and not the tree.

A. Interest

i. Interest, Discounts, and Premiums

Interest

- Interest on a loan is one of the most commonly encountered types of income from property.
- Interest is a periodic payment by the borrower to the lender for the use of the lender's money by the borrower.
- It is paid in addition to the repayment of the lender's principal.

Discounts and Premiums

- Not all returns for the use of borrowed money are paid as interest.
- Often a lender will realise gain in the form of a discount or premium on a loan in lieu of interest.
- The characterisation for tax purposes of these related types of gains is less certain.
  - While interest is definitively income in nature, discounts and premiums are traditionally seen as an additional return of capital.

Discounts

- When a loan is made at a discount, the "lender" will provide the "borrower" with less money than the amount that will actually have to be repaid.
  - E.g. "I loan you $200, you pay me back $300."
- Often this discount will be in lieu of interest payments.
- A discount arising at the outset of a transaction is commonly called "original issue discount".
- Subsequent discounts are "market discounts", which may arise if interest rates rise or the creditworthiness of the borrower weakens.
- Some debts instruments may offer no returns apart from a discount e.g. stripped bonds and zero coupon bonds.

Tax Consequences

- While discounts exhibit few of the usual characteristics of ordinary income, it is clear that they substitute for ordinary interest in most cases, particularly where a zero coupon note has been issued and there is no other return paid to the lender.
- In these cases, as a substitute for an income amount (interest), the discount would ordinarily be held to have acquired an income character.

Premiums

- When a loan is made at a premium, the borrower will be required to repay an amount (apart from interest, if any) in addition to the amount advanced or will be required to pay an initial sum to have the lender advance the amount.
  - E.g. "I will loan you $200, but only if you pay me $20 now for me to do so."

ii. Genuine Interest vs. Disguised Interest: Test

- The tax issue here is: "What is the *character* of the return? Is it income or capital?
- A "genuine" discount or premium will be capital in nature, whereas alternatively it could be held to be "disguised interest" i.e. income.
- There are two strands to the judicial tests used to distinguish discounts that are income and those that are capital gains.
  - 1. The first is based on the character of the lender. If the lender is a financial institution or regularly acquires discounted securities to generate business profits, the gains will be treated as business income.
  - 2. For other lenders, the character of a discount will depend on
    - The leading authority on this issue is *Lomax v Peter Dixon*.