TOPIC 2 - ASSESSABLE INCOME

Overview
- Assessable income is one of the major components used to determine taxable income and therefore the determination of assessable income is central to the income tax system: section 4-5.
- Assessable income is made up of ordinary income and statutory income. It does NOT include exempt income or amounts that are neither assessable nor exempt: s 6-1
- Section 6-5 defines ordinary income
- Section 6-10 defines statutory income
- Section 10-5 has the summary list of statutory tax.
- Section 6-15 defines what is not assessable income
- Section 6-20 defines exempt income.

1) ORDINARY INCOME
- Definition: "ordinary income" is income according to ordinary concepts: s 6-5 (1); Scott v C of T (NSW) (1935)
- Ordinary income must be earned. It must be received as cash or a benefit which is capable of being converted to cash: Tennant v Smith [1892].

a) Income earned from provision of services (personal exertion)
- In general, wages, salary and commissions are directly connected with employment services provided and so therefore will constitute income. Where a lump sum payment is made to an employee to retain their services this too will constitute ordinary income.
- Something can be earned as long as it is related to an identifiable service (whether past, current or future service): Hochstrasser v Mayes [1960].
- Something can be earned even if paid in a lump sum or paid by a third party (cf being paid by employer): Kelly v FCT (1985).
- Where payments are periodic they are more likely to be considered income in nature if coupled with other indicia of income: FCT v Blake (1984).
  - CF: if the payment is a once off lump sum it is more likely to be treated as a gratuity or capital in nature: FCT v Harris (1980).
- Prima facie, money paid by a third party will still be ordinary income (e.g. tips) Kelly v FCT, but a voluntary payment/gift/prize that is not for service or connected with employment will not be ordinary income (Hayes). However, a voluntary payment/gift/prize will be ordinary income (earned) if it is a product of services rendered by the person receiving the gift, or is connected with employment

**Kelly v FCT (1985)**
Earned when paid by a third party
Facts:
- In 1978, a Perth TV station announced they would give $20,000 to whoever won the Sandover medal (equivalent to the Brownlow).
- Kelly won and received the money and the Commissioner held that this was ordinary assessable income.
Held:
- The court held this was earned income even though it was paid by the TV station rather than the employer.
- It was ordinary income because Kelly was a professional footballer and there was a clearly recognizable connection between his work as a footballer and deriving the points that ultimately led to him receiving the Sandover medal (and hence the money).
i. Tips
- Tips will generally constitute income because the receipt is from recognition of the services provided. This is the case even though the payment may be unexpected and is made by a person other than the employer.

ii. Gifts
- Where the subject payments are in the nature of a gift, assessability will depend on whether the gift is a product of the taxpayer’s services or if it was given because of the taxpayer’s personal qualities: *FCT v Dixon* (1952).
- Receipts received as a gift are not earned and are therefore not income in ordinary concepts, thus are a non-earned windfall gain = not ordinary income: *Scott v FCT* (1966).
  - However, a Christmas bonus paid to employees is income in ordinary concepts due to direct connection with employment: *Laider v Perry* (1965).

**Scott v FCT**

**Facts:**
- The taxpayer was a solicitor who provided advice to a particular client over a long period of time and then subsequently for the client’s widow. The taxpayer assisted the widow in selling some land for a substantial profit. The widow subsequently gave gifts to a number of people, including the taxpayer.

**Held:**
- The gift was unexpected. The motive was friendship. It was not for services rendered by the taxpayer. The taxpayer had already been properly paid for his services = not ordinary income.

**SUMMARY: GIFTS V INCOME**
- A voluntary payment is prima facie capital and not income.
- If the payment is causally connected to employment or services rendered, then it is income.
- Where the recipient has been adequately rewarded for services rendered, the gift or voluntary payment is less likely to be income: *Scott v FCT*
- Even if the payment is made by a third party and not the employer, it may still be income.

iii. Prizes and chance winnings
- **RULE:** Prizes will not be income in ordinary concepts unless they are earned as a result of income-producing activities.

**Prizes won by professional sportspersons**
- Prizes that will be considered ordinary income are those received by professional sports men and women - connection or nexus between the receipt and the donee’s employment.
- Some factors used to determine if the prize is ordinary income or not ordinary income are:
  1. Degree of professionalism;
  2. Whether a reward for services compared to receipt for personal qualities;
  3. Whether recurrent or not; and
  4. Whether paid before or after service

**Prizes won by casual participants in competitions (Lotto, scratchies etc)**
- It is clear that the prizes from lottery winnings and other prizes purely dependant on chance are a windfall gain = not ordinary income.
However, if the prize results from the skill of the taxpayer, the area becomes cloudy.

- A once-off winner would have a windfall gain, but a person who becomes a prominent quiz competitor is more likely to have an income producing activity: *Case 37* (1966).
- The winnings of gamblers will be a windfall gain unless the gambler is in the business of gambling: *Prince v FCT* (1959).
  - NB: the courts have always been reluctant to elevate the activities of a gambler to the status of a business: *Evans v FCT* (1989)
- The winnings of a bookmaker are income, while the winnings of a casual punter will be a windfall gain.

iv. Signing-on fees
- A signing-on fee is money paid in a lump sum when someone starts employment.
- Signing on fees is not assessable income

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<th>Jarred v Boustead (1963)</th>
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<td><strong>Facts:</strong></td>
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<td>This case concerned an amateur rugby union player who relinquished his amateur status to play rugby League. He received £3,000 signing-on fee for relinquishing his amateur status.</td>
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<td><strong>Held:</strong></td>
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<td>Not assessable income (capital payment for relinquishing his status) - once-off lump sum payment.</td>
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v. Restrictive Covenants
- A restrictive covenant includes ROTs post-employment and regulation and restriction of trade during employment.
- Covenants that operate within employment are taken as being part of employment, and therefore any payment for that restrictive covenant will be ordinary income.
- A post-employment restrictive covenant restricts a capital asset, thus is not assessable income.
  - e.g. if A enters into a restrictive covenant that once employment with B terminates he will not work with C for 2 years and receives $10,000 – the restriction is a restriction of a capital asset (the capital asset is A’s right to work)

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<th>Higgs v Olivier (1952)</th>
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<td><strong>Facts:</strong></td>
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<td>Sir Lawrence Olivier produced, directed and acted in “Henry V” for which he was remunerated. Olivier received £15,000 for agreeing not to produce, direct or act for 18 months afterwards (Olivier entered into a restrictive covenant = ROT). The commissioner included the £15,000 in Olivier’s assessable income.</td>
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<td><strong>Held:</strong></td>
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<td>Olivier was giving up a capital asset (his right to earn, his right to work) and therefore the £15,000 was a capital receipt and not ordinary income.</td>
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vi. Termination/Compensation payments
- Where the taxpayer is compensated for the lost employment income through early termination of a contract the receipt will be income in ordinary concepts: *C of T (Vic.) v. Phillips* (1936)
- Similarly, compensation for accidents will be looked at in the same light: *Tinkler v*
On the other hand consideration for giving up valuable rights of a capital nature under a service agreement will not constitute ordinary income. This is because it does not arise in the course of employment, but represents the right to employment itself: *Scott v C of T (NSW)*

Payments to amateur sportsmen and women are also generally considered capital receipts where they are received for relinquishing amateur status or restraint of participation: *Jarrold v Boustead*

**b) Income earned from property**

- The passive ownership of property can give rise to the earning of income under ordinary concepts in many ways, namely dividends, interest, rent, royalties and annuities.

  **i. Capital assets examples (income v capital)**
  
  - Ordinary income is income which flows from the use of a capital asset: captured within s 6-5. Where the asset is sold it will be a capital receipt = not assessable income (see CGT instead).
    - Property (capital) v Rent (income flowing from use of an asset)
    - Loan-Bank Deposit (capital) v Interest (income flowing from use of an asset)
    - Shares (capital) v Dividends (income flowing from use of an asset)
      - NB: dividends are ordinary income. However, the same dollar should not be taxed twice = inequitable. Therefore, the ‘imputation system’ takes dividends out of ordinary income (s 6-5) and dividends are instead taxed under s 44 statutory income.
    - Business (capital) v Profits (income flowing from use of an asset)
    - Intellectual Property (capital) v Royalties (income flowing from use of an asset)
      - Royalties flow from the owner of IP to exercise a right of privilege (i.e. right to publish and/or sell works). Only a royalty if payment is tied to quantity (e.g. royalty of $4 per book sold): s 6-5
    - Investment (capital) v Annuity (income flowing from use of an asset)
      - Annuities arise where a capital asset is sold for an income stream – i.e. if a farm is sold in return for periodic payments that are equivalent to income: *Edgerton v Warburton.*
      - Unfair to include annuities in ordinary income, so annuities are taken out of s 6-5 and dealt with under s 27H – amount reduced to take into account the capital return.
  
  - Where the item sold was acquired for the purpose of sale (e.g. trading stock) then, even though the item sold may appear to be capital (e.g. blocks of land) the receipt still retains the character of income because the taxpayer holds the asset with the intention of turning it over for profit.
  
  - Where the assets sold are held for the commercial intention of making a profit, the proceeds of the sale are of an income nature: *FCT v Whitfords Beach Pty Ltd (1982).*
  
  - If the receipt is regular then it is more likely to have the character of income, whereas if it is once-off it is more likely to be capital in nature.
ii. Rental payments (an example of income flowing from use of capital asset)
   o Rent is clearly income in ordinary concepts because it flows from the employment of the capital and is normally described as payments made by a tenant to a landlord but can also include the lease or rental of goods and equipment.
   o There is little dispute as to the assessability of rental and lease payments EXCEPT for the issue of whether premiums paid to enter a lease agreement are income or assessable under the provisions of the ITAAs.
   o A premium is paid for the grant or assignment of a lease and is generally considered to be capital unless it is a substitution for rent, or the receipt of premiums is part of the lessor’s business: *Dickenson v FCT* (1958).

c) Income earned from a business
   - Proceeds from a transaction entered into in the ordinary course of a taxpayer’s business, is clearly assessable income.
   - As employees, not conducting a business.
   - If a receipt is derived from carrying on a *hobby* then the proceeds are not income. The proceeds may however be an assessable capital gain.

The definition of business contained in s 995-1 provides that the term includes ‘any profession, trade, employment, vocation or calling, but does not include occupation as an employee’

i. Normal Proceeds of a Business
   **Carrying on a business**
   - There is no definition of ‘carrying on a business’ within the ITAA. Accordingly, common law principles must be applied. Question of fact.
   - Often taxpayers will try and argue that they are conducting a business (not a hobby) to get a deduction. On the flip side, sometimes the commissioner will argue that the proceeds of the taxpayer’s activity are income from a business and therefore taxable.
   - None of the indicia is definitive or exhaustive – must weigh them up to determine whether or not the taxpayer is conducting a business. e.g. taxpayer may be organised, but does not have a profit motive and still be a business

**TWO QUESTION TEST:**
1) Is a business being carried on by the taxpayer, or is it merely a hobby or recreational pursuit?
   - NB: none of the indicia is, of itself, decisive, must weigh up all factors:
     *Ferguson v FCT*

a) System and organization
   - A hobby is not usually carried out in a systematic and organised way. A business is usually organised and run in an effective manner.
   - Enquire/seek more information on whether there is other evidence of structure and organisation and therefore of conducting activities in a business-like manner, e.g.:
     - Record keeping;
     - Staff;
     - Accounting; and
     - Maintaining an office
   - NB: taxpayer can still be carrying on a business even if they do things idiosyncratically or inefficiently.
Facts:
- The taxpayer was a retired naval officer. He wished to engage in primary production activities upon his retirement. To this end he began his activities while he was still in the navy, by leasing five cows.
- The taxpayer employed a management company to look after and breed from the cows. The taxpayer intended to breed the cows up to 200 then buy his own property.

Held:
- The taxpayer began his business when he began leasing his cows. This was the case even though no income would be derived for a number of years.
- The main reason the court considered he was running a business was because he carried on his activities in a systematic and organised manner. Further, the taxpayer was committed to his venture. Therefore, buying the five cows was the beginning of the business.
- Ferguson had a ledger or receipt for each animal – he had five animals (systematic and organised – court said it was).
- Alternatively, the tax commissioner could have concluded that leasing the five cows was a ‘pilot study’ to see if the business would be profitable. Meaning he would not start his business until he bought his own property.

b) Industry standards
- The courts will look at whether the taxpayer has applied the business methods and procedures ordinarily used in that type of business, i.e. whether the taxpayer is conforming to industry standards.

c) Nature of the activity
- The courts will view certain activities as being in the nature of hobbies. It is much more difficult to show that the taxpayer is carrying on a business in relation to such activities.
- Examples of activities that are viewed as hobbies (cf business activities):
  - Gambling *(Martin v FCT)*
  - Stamp collections
  - Coin collections
- Where the taxpayer purchases goods that are far in excess of his personal needs, the assumption is that the taxpayer is carrying on a business.