

# TAX LAW

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# TOPIC 1: INTRODUCTION

- ✚ Concerned with the following relationships:
  - Tax payable = (Assessable income x tax rate) – tax offsets; and
  - Taxable income = Assessable income – Allowable deductions.

## GENERAL STRUCTURE OF THE TAX ACTS:

- ✚ ITAA 97 – Div 2, 3 and 4 provide an overview of the structure of the new Act and explain the core purpose of the Act as the determination of taxable income.
- ✚ The following steps describe the basic procedure for determining the income tax due on taxable income as set out in the ITAA 97:
  - **S 4-1**: Who must pay tax?
  - **S 4-10**: Tax is paid each year ending 30 June.
  - Tax is based on taxable income less tax offsets.
  - **S 4-15**: Taxable income is calculated from assessable income and deductions.
  - **S 6-1**: Assessable income is classified into *ordinary income* (**s 6-5**) and *statutory income* (**s 6-10**).
    - It does not include *amounts that are neither ordinary or statutory income* (**s 6-15**) nor *exempt income* (**s 6-20**).
  - Division 8: Deductions are classified into *general deductions* (**s 8-1**) and *specific deductions* (**s 8-5**). In addition some expenses are excluded from deductibility altogether.

## STATUTORY INTERPRETATION:

- ✚ **S 995-1(1) ITAA 97** is a general definition provision that should be used if you require a definition of any word used in the Act.
  - Because the TLIP is still in progress some of the definitions contained in s 995-1(1) simply refer back to **s 6(1) ITAA 36**, which is the general definition section for the old Act.

## RESIDENCE OF TAXPAYER AND SOURCE OF INCOME:

### RESIDENCY:

- ✚ **S 6-5(2) and (3) & s 6-10(4) and (5)** distinguish between the assessable income of a resident and a non-resident.

- A resident of Australia is taxable on income from all sources whereas a non-resident is only taxed on income from Australian sources.

✚ **S 995-1** defines an Australian resident as having the same meaning as that given in ITAA 36 s 6(1). Section 6(1)(a) defines a **resident** to mean:

(a) A person, other than a company, who resides in Australia and includes a person:

(i) Whose domicile is in Australia, unless the Commissioner is satisfied that the person's permanent place of abode is outside Australia;

(ii) Who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied that the person's usual place of abode is outside Australia and that the person does not intend to take up residence in Australia ...

(b) A company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

✚ Test of residency, and test of domicile.

#### **SOURCE:**

✚ **S 6-5** and **s 6-10** provides that a resident taxpayer must pay tax on income from all sources, whilst a non-resident need only pay Australian tax on income with an Australian source.

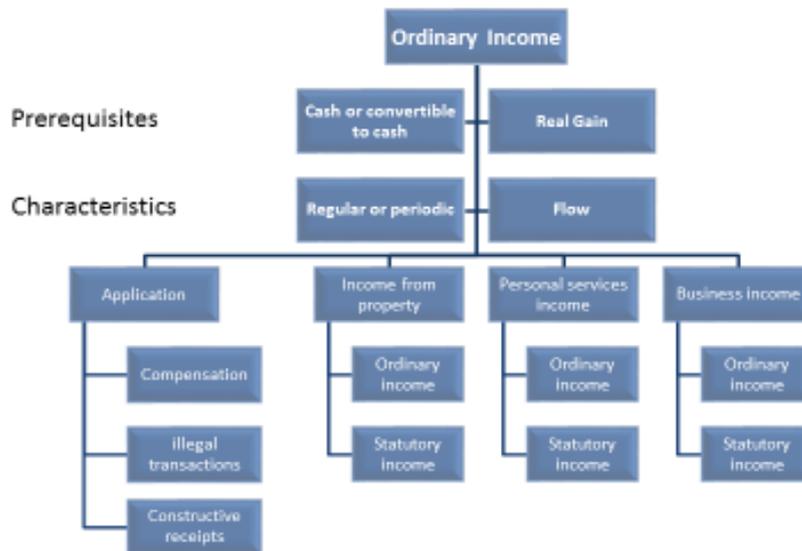
- This makes it important to be able to identify the source of a non-resident's income.

## TOPIC 2: ASSESSABLE INCOME

- ✚ Income tax = (Taxable income x Rate) – Tax offsets.
- ✚ Taxable income = Assessable income – Deductions: **s 4-15(1)**.
  
- ✚ AI not specifically defined in **ITAA 97** – however diagram in **s 6-1** gives a representation of the components that go to make up AI.
  - The diagram in s 6-1 shows that assessable income is made up of OI and SI.
    - It does not include exempt income, and amounts that are neither assessable nor exempt.
  - Division 6 then proceeds to define each of these components of assessable income.
    - **S 6-5** defines ordinary income, **s 6-10** defines statutory income, **s 6-15** defines what is not assessable income and **s 6-20** defines exempt income.
  
- ✚ **S 6-1** –
  - (1) Assessable income consists of **ordinary income** and **statutory income**.
  - (2) Some OI, and some SI, is **exempt income**.
  - (3) Exempt income is not assessable income.
  
- ✚ Thus need to consider the meaning of OI, SI and exempt income.

## TOPIC 2.1: ORDINARY INCOME

### Ordinary income: Overview



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#### INTERPRETATION:

- ✚ Your AI includes income according to ordinary concepts (**Ordinary Income**): s 6-5(1).
  - Thus, ordinary income is defined as 'income according to ordinary concepts'.
  - However there is no further indication in either ITAA's which sheds additional light on the meaning of this phrase. Thus necessary to consider cases.

#### **Operative provisions**

##### **6-5 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 section 10-5 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.

- ✚ ITAA 36 previously used the term *gross income* in s 25(1). This has now been redrafted in s 6-5 ITAA 97 as *income according to ordinary concepts*.

- The courts have also not offered an explicit definition – they have instead identified characteristics which they say are attributable to receipts that are income in nature.
- Case law has indicated that income for tax purposes takes its everyday meaning – it does not follow an accounting or economic definition.
  - This judicial concept of income has identified certain prerequisites and characteristics – these are necessary but not sufficient conditions for an item to constitute ordinary income.
  - Thus, both the prerequisites AND the characteristics need to be present. If both these are present, it makes an item more likely to be ordinary income.

🚦 Principles of interpretation that apply:

- What receipts ought to be treated as income must be determined in accordance with *ordinary concepts and usages of mankind*, except in so far as statute dictates otherwise: *Scott v FC of T*.
- Whether the payment received is income depends on a close examination of all relevant circumstances: *The Squatting Investment Co Ltd v FC of Tax*.
- It is an objective test: *Hayes v FC of T*.

**PREREQUISITES AND CHARACTERISTICS:**

**PREREQUISITES:**

🚦 The prerequisites are:

- That the gain must either be cash or cash convertible (*Federal Coke Co Pty Ltd v FCT*); and
  - Was held in *FCT v Cooke & Sherden* that amounts that cannot be converted to cash are not income in ordinary concepts, and s 21 of the Act could not give a money value where the non-monetary consideration could not be converted into cash or the right transferred to a taxpayer.
- That there must be a real gain: *Hochstrasser v Mayes*.
  - This prerequisite is mostly applied to employment situations.

🚦 ***FCT v Cooke & Sherden*** – Taxpayer sold drinks door to door. The taxpayer received a free holiday from the soft drink manufacturer as a result of them selling a certain number of drinks. The holidays were non-transferrable (could not be sold).

- Issue – Was the receipt of the holiday regarded as ‘ordinary income’?
- Held – No. The holiday was non-cash convertible, and could thus not be regarded as ordinary income.
  - Court followed the principle in the case of *Tennant v Smith*.

- ✚ **Tennant v Smith** – The taxpayer was an agent for a bank and lived in free accommodation supplied by the bank. The TP was not allowed to sublet the accommodation.
  - Issue – Was the accommodation OI and hence AI?
  - Held – No. The accommodation was neither cash nor cash convertible, and was thus not regarded as ordinary income.
  
- ✚ **Payne** – Payne travelled regularly as a result of her employment with a large accounting firm. Flights paid for by employer as they related to business. She was offered to join Frequent Flyer program on one of these trips and she signed up and paid the fee. She accumulated a lot of points over next few years, most resulting from business travel (minor part was private 3%).
  - Issue – Did the free flights and subsequent FF points constitute ordinary income?
  - Held – No.
    - The tickets were not money or money worth and they could only be used by the program member or his or her nominee.
    - They could not be sold in any way or converted to money so they were not cash or cash convertible.
  
- ✚ **Hochstrasser v Mayes** – TP’s employer required him to move cities. TP sold his house in city he was leaving and received less than he had paid for it. The employer reimbursed him for the loss.
  - Issue – Was this reimbursement ordinary income?
  - Held – No. It was not a real gain because he had just been compensated for work related expense.
    - If the receipt was not work related however, it would then have been a real gain and thus ordinary income (and hence assessable).

### CHARACTERISTICS:

- ✚ The characteristics are:
  - The gain is regular/periodic;
    - A gain that is regular/periodic is more likely to be ordinary income than a lump sum; and
  - If something “flows” it is more likely to be OI; and
    - Courts have used analogies with fruits and trees to illustrate this concept: *Eisner v Macomber*.
    - Eg the sale of a business is the sale of the “tree”, so the gain is likely to be capital and not ordinary income. In contrast, everyday profits from the

business are the “fruits” that flow from the business tree and so are likely to constitute ordinary income.

- Ordinary income comes into the recipient.
  - An amount can only be OI if it comes into to the entity in that particular income year.
    - **S 6-5** states that an amount has come into an entity if it has been derived by the entity.
    - This means that unrealised amounts cannot be classified as OI for that particular year.
  - In addition, the courts have held that if receipt of an amount saves a taxpayer from incurring expenditure, then this doesn’t necessarily make the receipt OI – because ‘income is what comes in, it is not what is saved by going out’: *FC of T v Cooke & Sherden*

#### WHAT IS NOT ORDINARY INCOME:

- ✚ Ordinary income does not include:
  - Capital receipts;
  - Gifts;
  - Chance winnings;
  - Income from recreational activities; and
  - Non-cash receipts.

#### APPLICATION:

##### COMPENSATION PAYMENTS:

- ✚ Whether compensation constitutes AI will depend on the nature of the compensation: *C of T (NSW) v Meeks*.
  - Ie compensation takes on the same character as what it replaces.
- ✚ Payments for the loss or sterilization of capital assets are generally capital in nature (and hence not OI): *Glenboig Union Fireclay Co Ltd v IRC* and *Burmah Steamship Co v IRC*.
- ✚ Difficulties arise where the compensation is for unliquidated damages and the capital and revenue components cannot be identified.
  - In such a situation the Australian courts will not attempt to apportion the amount into revenue and capital components: *McLaurin v FCT*.
  - In essence, the Australian courts will treat the whole compensation as a capital payment (and not OI) as long as it contains some portion of capital, no matter how small that portion may be.

### MUTUAL RECEIPTS ARE NOT INCOME:

- ✚ A basic concept of income is that it must “come in” – ie it must be derived from some outside source.
  - There will thus not be any OI if the taxpayer is dealing with themselves.
- ✚ An organisation cannot derive income from itself.
  - Eg – think of a club that is carried on by its members for its members. If the members contribute financially to the club for an event and there is a surplus, this surplus will be given back to the members through the club and is not income.

### CONSTRUCTIVE RECEIPTS – THE AMOUNT MUST BE CHARACTERISED AS ORDINARY INCOME IN THE HANDS OF THE PERSON WHO DERIVED IT:

- ✚ The character of the receipt is determined by reference to the person/entity who derived it.
  - It is not determined by the character of the expenditure that produced the item:  
*GP International Pipecoaters v FC of T* and *Federal Coke Co Pty Ltd v FC of T*.
- ✚ In *Federal Coke*, the issue of a constructive receipt was also raised.
  - Eg, if the taxpayer directs her employer to pay part of her salary to her husband, this amount is still OI of the employee as a constructive receipts.
  - Constructive receipt of a payment that would have been OI if it had actually been received will constitute OI.
- ✚ ***Federal Coke Co Pty Ltd v FCT*** – Bellambi Coal Co Ltd coal produced (produced coke, fuel). This was done through its subsidiary companies. Fed Coke was one of these subsidies producing the coal/coke. Bellambi entered into many contracts for the supply of this material. Economic downturn and FC had issues. As result of downturn, one company that FC contracted with (Le Nickel) could not pay full contract price. The contract was varied and agreement reached to pay FC \$1m comp, and FC activities then ceased.
  - Issue – Was the \$1m ordinary income?
  - Held – No.
    - Initially payment made to Bellambi they were advised would be assessable income, so they arranged for it to be made to FC instead.
    - Commissioner assessed FC for the amount as income.
    - Court held not AI.

- Said that receipt was not compensation because Le Nickel did not have contractual obligations with FC that would have made them owe compensation.
- Lack of dealings between FC and LN meant could not be OI from dealings as business.
- Had Commissioner assessed Bellambi (and not FC) then could have been assessable in Bellambi hands. This would have been through concept of constructive receipt (that they constructively received comp payment and redirected it to FC).
- Important point: that constructive receipt of a payment that would have been OI if it had actually been received will constitute OI. **S 6-5(4)** also deals with this: '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'.

#### ILLEGALITY:

- ✚ The fact that a receipt is from an illegal activity, does not mean it is not assessable.
  - It is assessable provided it would have been assessed if the activity was legal.
  - Eg, assessed on proceeds of drug dealing (see deductions and *La Rosa*).