Ordinary Income:

Overview of terminology:

- Taxable income = assessable income – deductions (s 4-15 ITAA97)

- Assessable income = ordinary income + statutory income (s. 6-1(1) ITAA97)

  - But not exempt income and not non-assessable non-exempt income (s. 6-15 ITAA97)

  - The first step to calculating income tax payable is to determine assessable income

- Ordinary income = income according to ordinary concepts (s. 6-5(1) ITAA97)

- Statutory income = income that is expressly made assessable by a provision/section in the legislation

  - See s. 10-5 ITAA97 for the list

Ordinary income:

- Ordinary income is *"income according to ordinary concepts"* and is assessable under s 6-5 ITAA97

- Gains require characterization by courts to determine if the gain has income character

- A receipt cannot be ordinary income unless it fulfills both prerequisites:

- NOTE; even if the above prerequisites are satisfied, it is not by itself sufficient for the gain to be ordinary income

Prerequisites of ordinary income:

Cash or cash convertible:

- A gain cannot be ordinary income if it is not cash or not cash convertible

  - Cash convertible = the item must be readily convertible to cash

  - Receipt is not cash convertible if it is illegal to sell the goods – Payne v FCT (1996)

- Tennant v Smith (1892):

  - Part of taxpayer's remuneration for working at a bank was free housing

  - Courts said that they value of the housing is not cash or cash convertible, so therefore it is not going to be income (would now be covered by FBT rules)

- FCT v Cooke and Sherden (1980):

  - Manufacturer of soft-drinks rewarded best sellers with free holidays

  - Our taxpayer was a very good seller of soft-drinks and had a lot of free holidays

  - The court reinforced that the holidays are not cash or cash convertible as they could not be transferred to someone else or exchanged for cash – thus it is not ordinary income

- Remember: non-cash benefits are not ordinary income but may still be assessable under a statutory scheme

Real gain to the taxpayer:

- If a receipt is not a genuine gain it is not ordinary income

  - The taxpayer must be better off

- Hochstrasser v Mayes (1960):

  - Our taxpayer was required to move to a different location for work and in doing so they had to sell their house – and ended up losing a lot of money on the house

  - The employer reimbursed them for the loss of money on the house as a work-related expense

  - Court said there is no real gain – it is just the reimbursement of a work-related expense

- Reimbursements v allowances:

  - Generally, allowances are amounts that are not a predetermined amount connected to actual expenditure. As the employee is not expected to pay back any amounts not used for work-related expenses, you have to include an allowance in your assessable income

  - However, the reimbursement of a work-related expense held not to be a real gain thus is not ordinary income

- Mutuality principle = if the taxpayer makes a payment to himself or herself, there is no gain and the payment will not be ordinary income (instead NANE income under s 6-23 ITAA97)

  - Bohemians Club v Acting FCT (1918)

Characteristics of ordinary income:

Provided that both prerequisites of income are met, a gain will be ORDINARY income if it shows sufficient characteristics

- Note: the characteristics are only indicia as to what constitutes ordinary income; courts can widen their views to reflect modern day practices: FCT v Myer Emporium (1987)

Regular/Periodic receipts:

- Receipts that are regular, periodic, expected and relied upon can constitute ordinary income, even if they do not flow from an earnings source:

  - Government aged pension is periodic and therefore assessable income: Keily v FCT (1983)

  - 'Top' up payments that are regular, periodic and relied upon have the characteristics of income: FCT v Dixon (1952) (regular monthly 'top up' payments from employer while he served in the military)

- Lump sum payments are likely to be capital not ordinary income: FCT v Harris (1980)
- Youth allowance payments constitute ordinary income: Anstis v FCT (2010)

The flow concept:

- For a gain to be considered ordinary income it will have the following two related traits:
  1. A connection (nexus) with the earning source:
     - Income from property (eg; rent has a nexus from property)
     - Income from business (eg; an accounting firm's profit has a nexus with business)
     - Income from personal services and employment (eg; salary has a nexus with an employee providing services)
  2. It can be severable/removed from its earning source
- Eisner v Macomber (1920):
  - Something that is capital is like a tree; it is a source
  - Something that is income is like a fruit; the thing is coming from the source (the fruit is severable from the tree)

Other points of relevance:

- Legality of receipts does not affect their assessability
  - FCT v La Rosa (2003): La Rosa was a heroin dealer who was taxed on 7 years of income from illegal dealings. By following the rules, La Rosa was able to claim deductions from his expenses in relation to the heroin dealings (has since been banned)
- Constructive receipt rule
  - The taxpayer who is entitled to receive the income is the person who will be assessable on it, even if the actual gain is directed to someone else
  - Stops people being able to claim a lower tax bracket
  - s 6-5(4) for constructive receipts as ordinary income; s 6-10(3) for constructive receipts as statutory income

Income from personal services and employment:

- Courts have used a two-step approach to determine if an amount is ordinary income from personal services:
  1. Identification of the activity undertaken; and
  2. Determining whether the receipt is a reward for performing that particular activity

Ordinary income as a reward for nexus:

- Irrelevant whether payment are from ongoing regular employment contract or a one-off receipt contractually required to be paid for performance of a given task
  - Brent v FCT (1971): Taxpayer was the wife of a famous criminal and sold her story when he died– the payment is still ordinary income from the provision of personal services under s 6-5(1)
- Irrelevant whether benefit is provided by the entity for which the task was performed or by an unrelated third party
  - Kelly v FCT (1985): Kelly was a footballer who won the B&F trophy for the season – at start of season was announced winner of the award will be paid $20,000 by local TV station. Kelly tried to argue it was a prize; courts ruled that he won because of skills and expertise & didn't matter that the money came from someone other than his employer. Thus is assessable income.
- Courts are reluctant to say something is a gift; thus if you perform services and you receive some sort of gain because of it, it will be ordinary income
  - Brown v FCT (2002): Brown helped his friend make a successful property development deal and his friend gave him an expensive house as a gift to say thank you. Court decided Brown had clearly provided services and was provided with a gain for his services, thus was ordinary income and not a true gift.

Voluntary payments:

- Unexpected or voluntary payments received as a reward for service are ordinary income as the benefit is an incident of employment
  - Laidler v Perry (1965): Christmas bonus was paid to all past and present employees in form of a voucher that could be redeemed for goods. Decided that voucher was income as it arose out of employment, even though it was a voluntary payment.
- Voluntary periodic payments that act as a substitute for wages and are relied upon are ordinary income
  - FCT v Dixon (1952)

Gifts:

- Employers do not usually provide gifts to employees; they are usually rewarding past performance or creating goodwill for better future performance; thus is a service and treated as ordinary income
- However, if there is a strong personal relationship between the parties it can be treated as a true gift and thus not ordinary income
  - Scott v FCT (1966): Scott was a lawyer & worked for a couple. Over the years they developed a strong & genuine friendship. Husband died and Scott took care of all legal work involved for wife and was paid for it. Wife then gave Scott a substantial amount of money on top of the payment for services.

Court determined this was a true gift due to strong personal relationship and the services had been paid for separately.

Prizes and chance winnings:
- Windfall gains/chance winnings are not ordinary income (not a result of personal service or exercise of special skill)
  - Case 37: Taxpayer won significant sum of money off TV show. Not ordinary income as it was luck.
  - Kelly v FCT (1985)

Salary sacrifice:
- Income is only assessable in the year it is derived: s 6-5(2) ITAA97
- If personal service income is never derived, it will never be assessable: Ruling TR 98/1

Capital v ordinary income:
- Giving up a valuable right is treated as capital
- Sign-on fees treated as capital:
  - Jarrold v Boustead (1963): footballer who was offered a sign-on fee to become professional. Footballer argued lump sum was capital as giving up valuable right to play as an amateur. Court agreed – giving up valuable right is treated as capital
- Restrictive covenant treated as capital:
  - Higgs v Olivier [1952]: Olivier acted in a movie and after it finished was paid a lump sum not to act/direct in any other movies for 18 months. Oliver agreed and claimed amount was capital as giving up the right to act/direct other movies. Court agreed.
  - FCT v Woite (1982): Woite was a footballer who was paid a lump sum by North Melb football club for an agreement not to play for any other team if he ever moved to Melbourne. Court decided it was capital as gave up right to play for any other team.

Frequent flyer program:
- All things you get through frequent flyer programs are tax free
- Gain does not need to be cash or cash convertible under s 15-2 ITAA97
- Payne v FCT (1996): Payne travelled a lot for work so joined the Qantas frequent flyer program and accumulated a lot of points. Needed to be determined whether points from work trips should be taxed under s 15-2 as non-cash bonuses. Courts said the relationship is between her and Qantas and as such it is up to Qantas to decide how points are allocated. Thus all things you get through frequent flyer programs are tax free.

Income from property:
- s 6(1) ITAA36: income that is derived/flowing from mere ownership of property without active labour or business activities (passive income)
- The income flowing/derived from the property is generally ordinary income (s. 6-5 ITAA97)
  - However, gains from disposal/sale of property is usually statutory income under CGT rules: s 102-5 ITAA97

Rent:
- Rent is a payment by one party in exchange for the use of the other party's property for an agreed amount of time
- Receipt of rent constitutes ordinary income (even if it is a lump sum)
- Adelaide Fruit and Produce Exchange Co v FCT (1932)

Interest:
- The return that flow from the lending of money and is the compensation for the loss of that money: Richies v Westminster Bank (1947)
- Constitutes ordinary income

Dividends:
- Definition of dividend under s 6(1) ITAA36
- Gains by shareholders flowing from ownership of shares has characteristics of ordinary income; however may be made statutory income under s 44 ITAA36

Royalties:
- A royalty payment is a payment that is calculated based on the usage of intellectual property or quantity/value of a substance taken: McCauley v FCT (1994)
- S 15-20 deems royalties to be assessable as statutory income; except where royalties have the characteristics of ordinary income

Annuities:
- An income stream purchased in return for transfer of funds (or property) to an annuity provider
- s 27H ITAA36 makes the capital component of the annuity tax free; however the payment of interest is ordinary income under s 6-5 ITAA97

Lease income:
- S 15-25 ITAA97 states that amounts received by a lessor from the lessee due to failing to comply with a lease obligation to repair the premises is assessable income, provided:
  - The lessee has used the premises for producing assessable income; and
  - The payment is not ordinary income