DERIVATION

According to ITAA97 s 6-5, an amount of ordinary income is included in the TP's assessable income if the amount is derived in that income year. Therefore issue of when an amount was derived as income is relevant to determining which income year to include the receipt in.

Choosing the appropriate method

When an amount was derived depends on the accounting method on which it is accounted for – either a receipts or accruals basis. Which method to use is a question of fact having regard to the TP's circumstances at the time and the nature of the income, as no clear statutory direction is given on this matter (*Carden*).

The objective is to determine the accounting method that gives a substantially correct reflex of the taxpayer's true income. This entails consideration of what gains have 'come home' to the TP in a realised or immediately realisable form: *Carden

- Must determine the appropriate method for each amount having regard to circumstances at that time, rather than applying a particular method to a taxpayer's income on a global basis (*Carden*).
    - *Possible for a taxpayer with multiple types of income to adopt different accounting bases.
- As circumstances change, the TP may have to change accounting methods (*Carden, Henderson*).
- **Determination of appropriate method for measuring income entails consideration of the nature of the profession concerned and the actual mode in which it is practised: *Carden***
    - *Henderson*, *Arthur Murray*, *Carden* all provided professional services but accounted for differently.
- Commercial/accounting concepts are relevant but not determinative in selecting the most appropriate accounting method: *Arthur Murray*
    - e.g. Accounting principle of 'work in progress' not supported (*Henderson*)
    - Book-keeping methods are evidence but not determinative.
- Face value of debt is recognised, not the present value of the debt (i.e. do not take account of contingencies and/or time value of money when quantifying amount derived): *Carden*

Cash / Receipts Basis

On the receipts basis accounting method, income is 'derived' when it is received. Income only includes actual cash receipts; outstanding fees earned but not yet received will not be included (*Carden*).

Non-trading / Provision of services / Small business / Practising a profession

- **Generally the receipts basis is used for an ordinary professional who markets nothing but his own services and gathers only professional fees (*Carden*).**
    - *The smaller the operation, the more likely that a receipts basis is appropriate (e.g. *Carden*).
    - Not always the case: see *Henderson*, *Arthur Murray.*
- ***Receipts basis is appropriate where 'non-trading' income is generated (*Carden*). Indicia include:**
    - There is no stock inventory of vendible articles to be acquired, produced, carried
        - e.g. *Brent, Carden*
    - No fund of circulating capital from which income must be detached for actual enjoyment
    - The receipts represent a reward for professional skill and personal work to which expenditure only contributes in a subsidiary degree.
        - e.g. *Brent, Carden*
    - Expenditure does not correspond to or materially contribute to earnings.
- ***BUT there must be continuity of the practice of the profession.**
    - *Carden*: receipts basis appropriate for prior years, but accruals basis for the year leading up to his death

- <u>**Uncertainty of receipt is decisive**</u>
    - *If it is uncertain that outstanding fees will be paid, receipts basis most appropriate.
    - e.g. *Carden* – doctor was not assured that he would receive all fees charged.
- **Note the <u>constructive receipt</u> rule: ITAA97 s 6-5(4), 6-10(3)**
    - The moment the TP gains unfettered control in determining the fate of the income, they have constructive receipt. They do not physically have to have the income in their hands.
    - *Brent* (Gibbs J, obiter): Not pursuing debt does not equate to the face value of the debt being "applied or dealt with".

<u>**Conclude on Derivation:**</u>

- **Because the receipts basis accounting method is most appropriate, the [amount] was derived as income when it was received.**
- **This is / is not within the relevant income year, so it is / is not be assessable income.**

Carden's case

- TP was a medical practitioner.
- Up to 1 July 1929, TP prepared tax returns on an accruals basis, recognising income as amounts <u>earned</u> in the income year, ignoring whether the amounts were actually received (i.e. book debts were included).
- 1 July 1929 onwards, tax returns included only <u>cash receipts</u> (i.e. ignoring book debts – fees outstanding).
- TP died on 15 Nov 1935 – Commissioner assessing income for 1 July 1934 – his death.
- At time of death, his book debts totalled £4,556, of which £1,192 were doubtful and £486 were bad.
- Commissioner tried to calculate TP's income on <u>earnings/accruals</u> basis (i.e. included the book debts).
- **Income to be assessed on <u>receipts</u> basis for prior years (continuity of practising the profession).**
- **Income to be assessed on <u>earnings</u> basis for year leading up to his death.**

Brent

- Woman who provided the story of her husband to a newspaper.
- It was agreed that she would be paid $55,250 but in that year she was only paid $10,000. The rest was outstanding.
- **Income assessed on <u>receipts</u> basis → only $10,000 assessable.**

Accruals / Earnings Basis

On the accruals basis accounting method, income is 'derived' when the amount is <u>earned</u>. This will include any <u>uncollected fees</u> that are earned in that FY.

<u>*Trading / Manufacturing / Large Business*</u>

- **Generally, accruals basis is used to calculate income from trading and manufacturing businesses.**
    - Trading = buys and sells; Manufacturing = buys raw material, makes it up and sells the finished product.
    - *Trade debts due but not yet paid will be derived as income as soon as the debt arises.
- **BUT can also be a <u>large/sophisticated business</u> that provides services (e.g. *Arthur Murray*, *Henderson*)**
    - *The larger the operation, the more likely that accruals basis is appropriate (e.g. *Henderson*).
- ***Accruals basis appropriate where so-called '<u>trading income</u>' is generated (*Carden*). Indicia include:**
    - <u>Stock inventory</u> of vendible articles to be acquired, produced, carried
        - Income from sale of goods is derived when the goods are sold and a debt is created.
    - Pool of <u>circulating capital</u> from which income must be detached for actual enjoyment
        - e.g. *Arthur Murray* – fees held in 'suspense account' until lessons conducted.
    - <u>Expenditure corresponds</u> to or materially contributes to earnings.
    - <u>Business earning income</u>, rather than payments rewarding personal efforts/skill.
        - *Arthur Murray, Henderson, Gaslight*
- Make sure to <u>distinguish between trading and non-trading income</u> for such a business.
    - If there is non-trading income, it will be accounted for on a receipts basis:
        - Non-trading income entails something coming in – 'receivability without receipt is nothing'.

Where an accruals basis is used, the income will be derived when it is earned. There remains an issue of <u>WHEN the amount is earned</u>.

<u>Pre-payment for future provision of services / sale of goods</u>: *Arthur Murray*

Where amounts are received in advance of goods being sold or services being provided, they are earned as income only:

- **At the <u>discharge of the obligations</u> for which they are the prepayment**
- **When it is <u>unaffected by legal restrictions</u> (trust, charge) such that it is received <u>beneficially</u>**
  - *There is neither legal nor business unsoundness in regarding them without qualification as income.
    - There were no legal restrictions on the prepayments, but it would be <u>commercially unsound</u> to treat them as income.
    - <u>Prospect of refund</u> was relevant.
  - *Therefore as a matter of <u>business good sense</u>, the recipient should treat the fees received but not yet earned as income.

<u>Post-payment for services provided</u>: *Gaslight, Henderson*

- ***Amount is earnt when the <u>current liabilities have matured into recoverable debts</u>. i.e. Only once payment can properly be <u>demanded</u>, is it considered 'earned'.**
  - *Gaslight*: No debt/obligation of the consumer to pay for gas used during the relevant quarter arose until the meter had been read and an account based on that reading issued.
    - Reading the meter and giving the bill were <u>conditions precedent to the demand of payment</u>.
  - *Henderson*: 'Work in progress' of a profession cannot be treated as though it is trading stock. There is no basis to value of work so far performed, but for which payment cannot yet be demanded, as income.
- **This is the case even when there is a special arrangement to allow time to pay: *Henderson***
  - i.e. Once the fee has matured into a recoverable debt, it is derived as income even though the creditor <u>cannot yet enforce</u> the debt (the payment deadline has not yet arrived).

<u>Conclude on Derivation:</u>

- **Because the accruals basis accounting method is most appropriate, the [amount] was derived as income when it was earned. It was earned ...**
- **This is / is not within the relevant income year, so it is / is not assessable income.**

Arthur Miller (PRE-PAYMENT)

- TP provided dancing lessons.
- Received fees in advance for future lessons, held them in a suspense account until the lesson occurred at which time the fee was transferred into a revenue account.
- In practice the TP refunded amounts on request.
- **Fees to be assessed on an <u>earnings</u> basis → Not earned until lesson occurred.**

Australian Gas Light Co (POST-PAYMENT)

- Gas company in the business of manufacturing and supplying gas. Each consumer was given a meter; based on the meter readings, accounts were sent out to consumers.
- Because the sending of accounts was staggered, as at 30 June any year, there were large numbers of consumers whose meters would not have ben read yet for that quarter, and had not yet received accounts.
- **No debt or obligation on the part of the consumer to pay for gas used during the relevant quarter arose until the meter had been read and an account based on that reading issued (<u>accruals</u> basis).**
- **Therefore the unbilled gas as at 30 June was not derived as income in that FY.**

Henderson (POST-PAYMENT)

- TP is a member of a partnership of an accounting firm. He was distributed partnership income each year by way of salary and bonuses.
- Commissioner wanted to include the amount of fees earned but uncollected by the end of the FY.
- Only fees which have matured into recoverable debts can be included as earnings (only once payment can be properly demanded can they be included as earnings).
- This is the case even when there is a special arrangement to allow time to pay.
- **The uncollected fees did not derive as income, as they had not yet matured into recoverable debts.**