

(ORDINARY INCOME) (w4)

(Legislation: Sec 6-5 and Sec 15-2 of ITAA97)

Ordinary income is “income according to ordinary concepts” and is assessable under the **s6-5 Income Tax Assessment Act 1997** “Income according to ordinary concepts”

- Gains require characterization by courts to determine if the gain has income character
- E.g. **Jordan CJ in Scott V Commissioner of Taxation 1935** interpreted income to be determined “in accordance with the ordinary concepts and usages of mankind”

Prerequisites of ordinary income.

1. A receipt cannot be ordinary income unless it fulfils **both** prerequisites:



NOTE: the prerequisites gives precedents to ordinary income, it is not itself sufficient for the gain to be ordinary income

1. Cash or Convertible to Cash

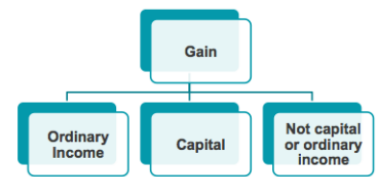
- A gain cannot be ordinary income it is NOT CASH or not CASH CONVERTIBLE e.g. **Tennant V Smith 1892** → Bank gave him a free house to work at the bank → cannot rent out → NOT ORDINARY income
- What is CASH CONVERTIBLE
 - Item must be readily converted to cash
 - Must not be illegal to sell the goods **Payne V FCT**
 - **Statutory** overrides provision: **s21A** ITAA36 and **s15-2**

2. Real Gain to the Taxpayer

- If a receipt is not a genuine gain, it is not ORDINARY INCOME
- Benefits that saves a taxpayer from incurring expenditure is NOT ordinary income

Characteristics of a Gain

- Central issue in application of the Australian Income Tax Legislation is the characteristics of a gain →



Characteristics of Ordinary Income

- Provided both prerequisites of income are satisfied, a gain will be ORDINARY income if it shows sufficient characteristics:
 1. Regular/Periodic receipts **OR**
 2. The Flow Concept

NOTE: The ^ characteristics are only indicia as to what constitutes as ordinary income → courts can widen their views to reflect modern day practices: **FCT V Myer Emporium 1987**

1. Regular/Periodic Receipts

- Receipts that are regular, expected and depended upon for support can constitute ORDINARY INCOME, even if they do not flow from an earnings source:
 - Government aged pension **Keily V FCT** (periodic there fore is ASSESSABLE INCOME)
 - “Top up” payments: **FCT V Dixon** War patron → Flow test got him

2. The Flow Concepts (Tree = Capital → Fruits = Income)

- For a gain to be considered ORDINARY income where it is likened to the fruit from the tree. It will have the following two related traits:
 1. A **connection (Nexus)** with the earning source
 - a) Income from Property (E.g. rent has a nexus from property)
 - b) Income from Business (E.g. an accounting firm’s profit has a clear nexus with business)
 - c) Income from Personal Services and Employment (e.g. salary has a clear nexus with an employee providing services).
 2. Can be removed (**Severable**) from its **earning source**

Other General Principles of income

- Compensation takes on the character of the loss being compensated (Car-Not Ordinary V Income - Ordinary)

- Legality of receipt does not affect their assessability **FCT V Las Rosa 2003** (Selling Drugs)
- Whether a receipt is ordinary income is to be characterized in the taxpayer's hands **Federal Coke Co Pty Ltd V FCT 1977**
- Constructive receipt rule: Entitlement to receive income VS gain being directed to someone else

Exempt Income

- Not included in ASSESSABLE INCOME
- E.g. First Class: Charities, Second Class PHD Scholarship, Third Class: Army

PREREQUISITES OF ORDINARY INCOME

Cash/Cash Convertible

Tennant V Smith (1892)
(Receipt from Free Accommodation **Not Ordinary**):

- Taxpayer = agent for a bank & lived in free accommodation supplied by bank
- **Conditions:** Taxpayer was not allowed to sublet the accommodation
 - **Court:** Accommodation was not regarded as income (not cash/cash convertible)

Non Cash/Cash Convertible

FCT V Cooke and Sherden (1980)
(Non cash convertible Holiday **Not Ordinary**):

- Taxpayer = Sold drinks "door to door"
- **Conditions:** Receives a FREE holiday from the manufacturer if they sell a certain number of drinks, Holiday was NON TRANSFERABLE cannot be sold.
 - **Court:** Holiday were not cash cannot be sold = not ordinary (not cash/cash convertible)

Non Cash/Cash Convertible

Real Gain

Hochstrasser V Mayes (1960)
(Reimbursement for work related loss upon moving premises **Not Ordinary**):

- Taxpayer = Employer requires him to relocate, taxpayer sold house he is relocating from
- **Conditions:** Taxpayer sold house for less than purchase price, employer reimburses him for the losses of selling his house
 - **Court:** Payment is NOT assessable → not a real gain because the taxpayer had been compensated for a work-related expense
 - If taxpayer is compensated for a non-work related loss = real gain = assessable income.

Real Gain

CHARACTERISTICS OF ORDINARY INCOME

Regular/Periodical Receipts

Keily V FCT (1938)
(Aged Pension=**Ordinary**):

- Taxpayer = pensioner
- **Conditions:** Received pension funds from the government
 - **Court:** Considered ordinary because *regular, expected and depended* upon by the taxpayer for support

Regular

FCT V Dixon (1952)
(Top-up pay=**Ordinary**):

- Taxpayer = joined the army therefore cannot perform ordinary work
- **Conditions:** Taxpayer receives top-ups from employer
 - **Court:** Considered ordinary because *regular, expected and depended* upon by the taxpayer for personal living expenses
 - Payments are compensation under the **compensation principle** → compensation for salary earned → therefore ordinary (loss compensated for)

Regular

Flow Concept

Federal Coke Co Pty Ltd V FCT
(ATO Loses because did not use the principle of constructive receipts =**Not Ordinary**):

- Taxpayer = subsidiary company asked to pay compensation to another subsidiary company.
- **Conditions:** Received compensation payments but made to subsidiary company instead of company being compensated for
 - **Court:** Receipt was not compensation, lack of dealings between Le Nickel and Federal Coke therefore could not be argued that the receipt was ordinary due to being the product of business activities

Flow Missing

RACV V FCT (1973)
(Mutual receipts of a club

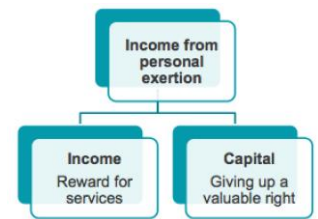
- Taxpayer = membership based club that provides a number of services to their customers
- **Conditions:** Offer services to clients e.g. vehicle testing, driving lessons, referrals etc.
 - **Court:** Issue: whether the services made were provided to members only or part of trading activities.
 - Towing services, vehicle testing, journal and travel expenses are mutual
 - Advertising, financial and insurance services and driving lessons are non members and non mutual

(ORDINARY INCOME) INCOME FROM PERSONAL SERVICES AND EMPLOYMENT (W4)

(Legislation: Sec 6-5 and Sec 15-2 of ITAA97)

Overview

- Receipts from employment/personal service = INCOME TAX or FBT
- Ordinary Income (**Sec 6-5 ITAA97**)
- Allowances and other things provided in respect of employment or services (**Sec 15-2**)



Income from Personal Exertion: *Rewards from services Nexus*

- A connection with a receipt resulting from a taxpayer's personal service constitute to ordinary income:
Wages (Clear nexus = Ordinary Income) → Gifts (No nexus = not ORD)
- Courts have used a 2 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 (determined by the courts) | |
|--|--|
| <u>Clearly Established</u> <u>(ORD)</u> | <ul style="list-style-type: none"> • <i>Salary and Wages</i> e.g. Brent V FCT 1971 Taxpayer was wife of a famous criminal → Sold story Payment is ordinary income from provision of personal services assessable under s6-5(1) • <i>Fees</i> charged for services rendered • Ancillary payments that are an <i>incident of labor</i> |
| <u>Non-Cash Benefit</u> <u>(ORD/s15-2)</u> | <ul style="list-style-type: none"> • A non cash payment may have nexus with personal exertion BUT ORDINARY = CONVERTIBLE to cash • E.g. Payne V FCT Frequent Flyer pts = not convertible to cash → can be assessable under s15-2 or FBT NOT s15-2 = third requirement not satisfied (in respect of....employment) Pts = 3rd party |
| <u>Uncertain (ORD)</u> | <p><u>Voluntary Payments</u></p> <ul style="list-style-type: none"> • Unexpected/voluntary payments received in an incidence of employment = (Ordinary Income) Calvert v Wainwright tip money as a taxi driver (would not have this if didn't work) • Possible characteristics of ordinary income based on the nature of payment FCT v Dixon (Enlisted into the army → old employer paid difference → flow test got him) <p><u>Prize</u></p> <ul style="list-style-type: none"> • Price and chance winnings non-assessable if the gain is <u>luck</u> Kelly V FCT 1985 → AFL best and fairest • Ordinary Income will depend on degree of <u>personal exertion</u> and <u>luck</u> Case 37 – Game show Luck |
| Former Employee and Gifts | |
| <u>Gifts (ORD)</u> | <ul style="list-style-type: none"> • For <u>personal qualities</u> is NOT regarded as ORDINARY INCOME • For <u>ability to work</u> or <u>employment contract</u> is ORDINARY INCOME <p>Scott V FCT Importance of personal relationship b/n parties. "Money" = not for service = NOT ORDINARY</p> |
| STATUTORY INCOME FROM SERVICES AND EMPLOYMENT (determined by government) | |
| <u>Restricted Covenant</u> <u>(CGT)</u> | <ul style="list-style-type: none"> • Can be (1) on entering a contract, (2) During the contract's operations or (3) On conclusion of contract • Ordinary income = if connected with current employment (future services) Reuter V FCT (1993) • Capital Gains Tax <ul style="list-style-type: none"> - Separate agreement to give up valuable right: Higgs V Olivier 1952 (Famous Actor → paid not to act) or FCT V Woite 1982 (Famous AFL Player) - No connection with earnings activity Hepples V FCT 1991 (Paid not to work for competitor after retirement) |
| <u>Relinquishing Rights</u> <u>(CGT)</u> | <ul style="list-style-type: none"> • A <u>gain</u> from a change to entitlement under employment/service contracts takes the character of what it replaces • E.g. Bennet V FCT 1947 Rights to control a company as Managing Director → company compensate him → assessable under CGT |
| <u>Sign on Fees (ORD)</u> | <ul style="list-style-type: none"> • Sign on fees = attracting new people for new employment contracts = payment for future services = Ordinary Income Pickford V FCT 1998 |
| <u>Services and Employment (s15-2)</u> | <ul style="list-style-type: none"> • Provision to bring GAINS from LABOUR into ASSESSABLE INCOME (broad provision that brings the value of certain gains from labour into assessable income) • Applies when the following 3 Requirements are satisfied <ol style="list-style-type: none"> 1. There is an Allowance, Gratitude, Compensation, Benefit, Bonus or Premium 2. Provided to the taxpayer 3. Connection with employment or service provided <p>In MONEY or any other form → if GIFT not caught under anything (no connection)</p> <p>Relationship with other tax provisions</p> |

| | |
|--|---|
| | S15-2 will not appear if gain is FBT s23L(1) or ORDINARY INCOME s6-5 |
|--|---|