Indicators of Ordinary Income

- character of payment in hands of taxpayer
- periodicity, recurrence, regularity
- cash or convertible into cash
- must “come in” to the taxpayer during the relevant income year
- nexus (connection) with an earning activity

Must take into account all of these indicators and balance them against each other to determine whether or not an amount is ordinary income.

<u>Character of payment in hands of taxpayer</u>

- this indicator means that you must look at the character of the payment in the hands of the taxpayer rather than the payer
- the motives of the payer may be relevant, but are seldom, if ever, decisive in characterising a receipt
  - *Federal Coke Co Pty Ltd v FCT 77 ATC 4255*
    - long term sales contract, Le Nickel agreed to purchase coke from Bellambi
    - Le Nickel wanted to get out of the contract, paid release fee to Federal Coke instead of Bellambi, payment also stated it was to compensate for the closing down of the factory if they were released from the contract
    - Held: because federal coke received the payment it was akin to a gift, you look at the character of the payment in the hands of the taxpayer not anyone else. If it had been Bellambi who received the payment, the outcome would have been different.
- the payment may take a different character for different parties to the same transaction
  - *Just v FCT (1949) 4 AITR 185* and *CML Society Ltd v FCT (1953) 89 CLR 428*
    - Just agreed to sell land to CML society, in return for rental charge being provided from CML to Just.
    - Land for Just was deemed income
    - CML wanted to claim deductions for rental charge, however instead of it being income, it was defined as capital and couldn't be deducted

<u>Periodicity, Recurrence, Regularity</u>

- In general if a payment is made regularly and periodically, it will be considered income
  - *FCT v Blake (1984) 84 ATC 4661*
    - bank employee retired and bank agreed to pay him additional top up payment for his pension
    - held: was ordinary income as bank employee used regular payment to sustain mode of living, payment was periodic and regular
  - *FCT v Dixon (1952) 86 CLR 540*
    - taxpayer voluntarily listed for service in military for 5 years, during this time employer agreed to provide him with top up payments. They paid him difference between military salary and old job salary. No agreement that clark would return to the previous employment. Were the voluntary payments ordinary income or capital?

    - Held: was ordinary income
        - why? factors included: payment was regular and periodical, it arose out of circumstances relating to employment, he depended on receiving those payments as regular income
    - payment made in substitution of salary and wages had he remained in the employment during 5 years, therefore should be treated as if he had continued
- By contrast, amounts that arise infrequently and unexpectedly are often capital in nature
- However, this is not the only factor. One-off payments have been found to be income in nature in certain circumstances, as have periodic payments been deemed capital

<u>Income must “come in” to the taxpayer and be “money” or “convertible into money”</u>

- income must generally be received as money or in a form that is convertible into money otherwise there is no “gain” that can be taxed
- must come in during the relevant income year
    - *Tenant vs Smith*
        - payment of rental expenses by employee on behalf of employee
        - Held: amount was capital as the money wasn’t actually coming in to the employee; no physical cash, convertibility and coming in concepts
    - *FCT v Cooke & Sherden (1980) 80 ATC 4140*
        - tax payer provided with free holiday by employer
        - amount didn’t come in to taxpayer themselves
    - *The Countess of Bective v. Federal Commissioner of Taxation (1932) 47 CLR 417*
        - amount received by trustee of trust for benefit of someone else
        - amount hadn’t actually come in to taxpayer therefore not income
    - *Payne v FCT*
        - employee signed up for Qantas frequent flyer program, employer paid for all of her flights
        - commissioner tried to tax the value of a flight purchased with her points earned
        - points could not be converted into cash, therefore not ordinary income
- in order for income to “come in” to taxpayer it must come from “outside” sources - taxpayers cannot derive income from themselves; this is known as the mutuality principle (*The Bohemians Club v FCT)*
- NB “coming in to the taxpayer” and being cash or convertible into cash are heavily linked

Also note: non-cash benefits are now captured to counter-act some of these cases.

- Section 21(1) of ITAA36:
    - Where consideration not in cash
        - (1) Where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given.
        - (2) This section has effect subject to section 21A.
- See also ss 21A and 23L of ITAA36.

Nexus (connection) with an earning activity

- Test: Can the amount received be characterised as an "amount that is a product or ordinary incident of employment or a reward for services rendered"? See Scott v C of T below
- Consider the extent of the connection between the services or employment relationship and the amount received.
- *Scott v C of T (NSW) (1935) 35 SR (NSW) 215*
  - agreement that scott would be paid 7000 pounds as compensation for disbandment of board of which he had been chairman for 5 years
  - classified as ordinary income because was the same amount he would have been paid if he had continued
  - BUT courts held: it is a capital amount because he was now unemployed, no connection with earning activity because no longer can earn, one off payment
- *Kelly v FC of T*
  - professional football received $20,000 award from channel 7 for being awarded best and fairest
  - Held: sufficient nexus with taxpayer's employment to constitute income
  - Note: an award or prize received by a taxpayer that has no link to employment would not generally be of an income nature unless it arises in the course of carrying on a business; would therefore constitute an ordinary business receipt. See case: *FC of T v Stone*
- *FCT v Dixon (1952) 86 CLR 540*
  - Requirement for a nexus with an earning activity is a fundamental concept in most cases
  - However, a lack of nexus will not necessarily be fatal to characterising an amount as income (particularly if the receipt satisfies the periodicity, regularity or recurrence test).
- Note: income does not necessarily have to come from employer, could come from a TP

Special categories of ordinary income

- Compensation payments
  - FCT v Dixon (1952) 86 CLR 540
- Reimbursement payments
  - FCT v Rowe (1997) 187 CLR 266
    - Taxpayer reimbursed by employer for legal costs
    - Tax payer's legal costs to lawyer also deductible
    - Reimbursement; one off ex gratia payment therefore capital and not ordinary income
  - Subdiv 20-A of ITAA97
    - introduced to counteract situations like FCT v Rowe
- Income from illegal or immoral activities
  - Partridge v Mallandaine (1856) 2 TC 179
    - income gained by burglary business by taxpayer; deemed ordinary income
  - FCT v La Rosa 2002 ATC 4709
  - Sections 26-52, 26-53 and 26-54 ITAA97

- What about gifts, windfalls and hobbies? Calvert v Wainwright (1947) 27 TC 475; cf Scott v FCT (1966) 117 CLR 514.
  - generally <u>not</u> categorised as ordinary income as one off and no connection to earning activity
  - exception: tips for work e.g. taxi driver, waitress etc.

Topic 4

Income from personal exertion

Income may be divided into four broad categories:

- **income from personal exertion**
  - includes remuneration from employment (Dean & Anor v FCT) and rewards from rendering personal services (Brent v FCT)
  - rewards for services and payments incidental to employment, but to gifts or payments for relinquishing or restricting rights
- **income from business**
  - includes the ordinary proceeds of a business (Blockey v FCT) and gains from trading activities (California Copper Syndicate Ltd v Harris)
  - not gains for the mere realisation of capital assets
- **income from profit-making scheme**
  - includes gains from isolated commercial transactions that are entered into with the purpose of making a profit (FCT v The Myer Emporium)
- **income from property**
  - includes amounts such as rent from a lease (Adelaide Fruit and Produce Exchange Co Ltd v DCT of T) and interest on a sum of money (Riches v Westminster Bank Ltd)
  - flows from the use of capital assets but not gains accruing to capital assets