Australian Income Tax Summary

A. INTRODUCTION

- **Roy Morgan Research 2011 HCA** → found that something can still be a tax even if its purpose is more for regulating activity that creates minimal revenue. Therefore, the Commonwealth is able to regulate in areas that are effectively within state power.
- A tax is distortionary if it effects people's behaviour and therefore an efficient tax should not affect your economic decision making.
- Tax incidence is who has the legal obligation of paying the tax. C.f. the tax burden is who is hurt economically by the tax policy.
- An interesting implication of the progressive marginal tax rate is that deductions become more valuable.
- **Section 55** of the **Constitution** requires that laws imposing taxation shall deal only with the imposition of taxation and furthermore with only one subject of taxation.
  - Although consider implication of **Roy Morgan**
- A tax system is judged through three criteria:
  - **Equity**
    - Horizontal equity (those in similar situations pay the same) and vertical equity (rich pay more than poor)
  - **Efficiency**
    - The effect to which the tax rules affect people's behaviour/ economic decision making i.e. exhibit market distortion.
  - **Simplicity**
    - Administrative ease helps with compliance and government administration
- Deductions v Offsets
  - Deductions reduce your taxable income i.e. assessable income. Offsets reduce the final amount of tax you have to pay after calculating tax payable.
  - These are both examples of tax expenditure

Taxable Income = (Income - Deductions)

aka assessable income

Tax payable = (Income - Deductions) x Rate - Offsets

Income = Ordinary Income + Statutory Income

B. CONCEPTS OF INCOME

1. **Has there been income?**
   a. **Is it considered <u>ordinary income</u> under s 6-5?**
      i. Under **ITAA 1997** → **s 6-5** your assessable income includes 'ordinary income' which is 'income according to ordinary concepts'
         1. The legislation provides little guidance on the substance of ordinary income and therefore guidance is taken from the common law.
            a. "Ordinary concepts and usages of mankind" **Scott v C of T (NSW)**
      ii. There is a general agreement dividing the judicial concept of income into three broad areas:
         1. **Income from services**
            a. A gain from a reward for services (e.g. salary, wages, certain gifts) has the character of income)
         2. **Income from business**
         3. **Income from property**
            a. Dividends, interest, rent and royalties.
            b. C.f. is distinct from a return from sale of a property which is a capital gain and does not have an income character
         4. **Income from compensation**
            a. Amounts received in compensation for any amount that would have been received which has the character of income (e.g. income insurance)

      iii. **Has there been a flow? i.e. Has the income been realised?**
         1. Under **Parson's First Proposition** → An item of income character is derived when it has "come home" to the taxpayer.
            a. This is demonstrated by Lord Denning in **Abbott v Philbin 1961 UK**
         i. The value of a share option at any given time might fluctuate – but until you exercise the right – nothing can be assessed or calculated as to what that gain is.
         ii. *"A bird in the bush is not taxable, even if you have the right to get it in the future, if it is still there. You must have it in your hand before you can be taxed for it*".

      iv. **Has there been a gain?**
         1. Under **Parsons' Fourth Proposition** → To have the character of income, the item must be a gain to the taxpayer who derived it
            a. This is demonstrated in ***Hochstrasser v Mayes* [1960] AC 376** where the individual was deemed to have been compensated for a loss – therefore there was no gain and it wasn't income i.e. brought them into the same position.
         i. Facts: The taxpayer was required to move for their employment and had to sell their house at a loss - therefore the employer gave them a receipt of money equal to the amount of loss.
         ii. Although there was a flow of money there was no gain.
         iii. Note the case did differentiate this from when an employer would indemnify employee against losses on trading unattached from employment – these would be indemnity payments as a straight reward for services.

v. **Does the taxpayer hold that flow and gain for themselves? i.e. do they have the beneficial interest?**

1. Under **Parson's Fifth Proposition** → There has been no gain unless an item is derived by the taxpayer beneficially
2. This was considered in **The Countess of Bective v FCT 1932 HCA** where the taxpayer received trust distribution with a restriction on the use of the money to be used for maintenance and education of her child. Because the money had to be used for a certain purpose unrelated to her, the money was seen as not a personal gain and therefore not income.

vi. **Relevance of the taxpayer and the tax event**

1. **Circumstances of the taxpayer**
   a. Under **Parsons' Third Proposition** → The character of an item as income must be judged in the circumstances of the taxpayer, without regard to the character it would have had if it had been derived by another person.

   i. In **Federal Coke**, FC was a subsidiary of BC and was used to fulfil a supply contract that BC had with LN. LN wanted to vary the contract by ending it early and had to pay essentially a termination fee to BC (i.e. compensation for income – so it's income). BC directed to pay the fee to FC so it would be treated as a gift rom FC and not income – because FC would not have received the money under the normal contract terms. The Court maintained this was valid.

   ii. Legislation has intervened to prevent this occurring and developed the concept of 'Constructive receipt' under

      1. **Ordinary Income ITAA 1997 s 6-5(4)** → 'in determining whether you have derived ordinary income, 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**"
      2. **Statutory Income s 6-10(3)** → "If an amount would be statutory income apart from the face that you have not received it, it becomes statutory income as soon as it is applied or dealt with in any way **on your behalf or as you direct**"

   iii. In the same circumstance it would have been treated as if received by BC first and then passed on to BC – so still income to BC and taxable.

2. **At what <u>time</u> was the income derived?**
   a. The income characteristics must be present at the time the income is claimed.
   b. Considered by the HCA in **Constable v FCT 1952**:

   i. Facts: Employer and taxpayer both contributed to super – personal contributions were recoverable in certain events. These contributions were matched by employer but entitled was contingent on conditions i.e. certain years of service – the tax payer met these conditions and 'vested' their interest sometime after contribution was made.

   ii. The taxpayer withdrew under the terms of the trust due to a change in trust terms and was being assessed for tax on income – at what time was the income derived?
   iii. Three possible options:
      1. **Contribution**
         a. N.b. that taxpayers personal contributions were to be taxed as income even though they didn't go directly to employee by way of constructive receipt – wasn't disputed.
         b. Held that employer contributions and their interest and that interest on individual contributions were not taxable.
         c. Different reasons were given → majority was that these amounts were not given to him in the year or assessment – the money was capital so did not have the income characteristics
      2. Vested
      3. Cashing-out
         a. Amount includes growth on the asset. Tax office tried to argue this was the time for income and therefore tax would be paid on growth – this failed.

b. If it's not ordinary income, is it included as <u>statutory income</u>?

   i. Under **s 6-10** assessable income is expanded beyond ordinary income to include specific amounts:
      1. Also note that statutory. Income does mention some amounts that would be considered ordinary income anyway. The statute mentions them to clear any ambiguity.

c. What is the amount of income? (valuation)

   i. Under **Parsons' Second Proposition** → An item of an income character that has been derived will be income in the amount of its realizable value.
      1. Consider that the legislation is as follows **ITAA 1936 s 21** → Where consideration is given other than cash, the money value of that consideration is taken to have been paid.
      2. However, in practical terms this isn't as easy **–**

What about non-convertible benefits? *note consider that it might come under fringe benefits

   a. The English judicial test was derived from the case **Tennant v Smith 1892**, where an employee was provided with accommodation above the workplace – because he wasn't allowed to sublet and therefore turn into cash – therefore was not ordinary income.
   b. This principle was applied in the Australian case **FCT v Cooke and Sherden 1980** where, as a bonus from a manufacturer the business operator received a free holiday that was not convertible into cash → because it wasn't convertible the court held it's not taxable income according to <u>ordinary income principles</u>.

i. "if a tax payer receives a benefit which cannot be turned to pecuniary account, he has not received income as that terms is understood according to ordinary concepts and usages"

c. Note that the actual decision here was reversed by amending the **1936 Act** in **s 21A** where if you operate a business and receive a non-cash benefit – it will be treated as if it was convertible to cash. However, the principle remains the general principle.

d. Was the amount excluded from tax by being classified as exempt income nor non-assessable non-exempt income (NANE)?

i. Although the amount may be considered of 'income character' under ordinary or statutory income, it may be excluded under assessable income by provisions under the statute from being considered as assessable under **s 6-15**.

ii. The statute may deem some income as '**exempt**' and therefore tax is not paid on it. However:

1. Exempt income may still be taken into account when calculating the amount of a tax loss.
   a. Important because losses are carried forward.
2. You cannot include any expenses incurred as a result of deriving that income as a deduction.

iii. The statute may deem some income as 'non-exempt non-assessable' and therefore tax is also not paid on it – however it isn't included when calculating the amount of tax lossess

1. Important because losses are carried forward.

e. Is it partially income and partially increase in capital?

i. The ATO will seek to apportion the amount into its income and non-income elements but the ATO's power to do so in Australia seems very circumscribed and if apportionment is not possible the payment can be treated as not being income at all.

ii. Leading authority → **McLaurin v FCT (1961) 104 CLR 381**

1. Facts: taxpayer's property was destroyed in a fire caused by Railways Commissioner and was granted damages - the amount of which was recommended by a valuer based on a list of items damaged but the taxpayer was not informed of any means by which the lump sum was calculated.
2. ATO sought to assess the taxpayer on some of this claiming it was income (accepting that the other part of it was capital).
3. The HCA refused to portion in this case – saying the whole of the damage which it did was compensated for by the one entire sum and it's not true that the sum took the place of assessable income.
4. It may have made a difference here if the taxpayer knew how the final valuation had been made and accepted this calculation.

f. Was the amount a fringe benefit?

i. *See fringe benefit topic below.*

g. Was the amount a capital gain?

i. *See CGT below*