

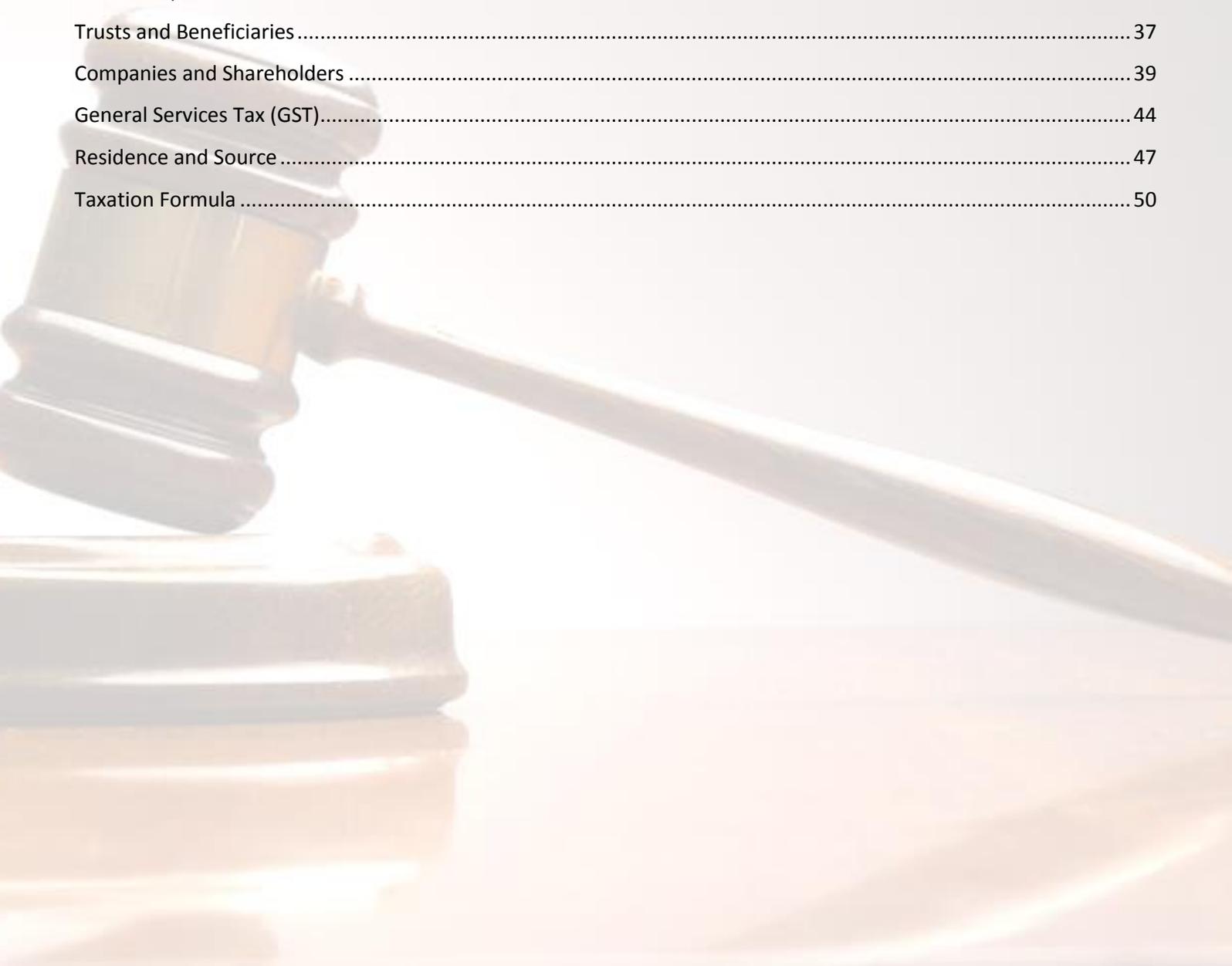


Revenue Law

By Zohra Arbabzada

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Ordinary Income

Question 1: Identify general principles underlying ordinary income

- **S 6-5 ITAA 97** tells us that ordinary income constitutes assessable income
- **S 6-58 ITAA 97** tells us that ordinary income is “income according to ordinary concepts”
- **Is it ordinary income?**
 - **Element 1: Is the income cash or cash convertible? – FCT v Cooke & Sherden**
 - **FCT v Cooke and Sherden** tells us that a non-convertible holiday is not considered income
 - Receipts that are not convertible to cash are not ordinary income
 - The case **Tennant v Smith** tells us that the yearly value of privilege of free residence is not cash convertible, therefore not income
 - **Payne v FCT** tells us that frequent flyer reward points are not ordinary income
 - **Exception:**
 - **S 15-2 ITAA 97** will make the money derived ordinary income, despite its non-cash convertibility, if there exists a nexus to employment or services.
 - **S 23L ITAA 36** tells us that the money derived may also be subject to fringe benefits tax when the person is an employee
 - **Element 2: Is the income a real gain? – Hochstrasser v Mayes**
 - Re-imbursment for travel expenses for travelling to a different place for work is not a real gain because it is compensatory. On the other hand, reimbursing you for going overseas for business is a real gain because the gain is being made on top of or in addition to your regular salary.

Question 2: What are typical characteristics of ordinary income?

- **Characteristic 1: It tends to be regular/periodic**
 - Fortnightly, weekly, monthly, etc
- **Characteristic 2: The income must flow from its source**
 - An example would be rent flowing from investment property)
 - The case **Eisner v Macomber** tells us that an increase in the value of land without selling the land is not ordinary income
- **Characteristic 3: Severable without affecting underlying property**
- **Characteristic 4: Reliance**
 - The case **Kelly v FCT** tells us that government pensions constitute ordinary income
 - **FCT v Dixon** tells us that top up payments by a former employer constitutes as ordinary income

Question 3: Can an illegal receipt constitute ordinary income?

- Yes. The fact that a receipt is from an illegal activity does not prevent it from being assessable. The case **Partridge v Malladine** tells us this.

Question 4: Identify what a constructive receipt is.

- **Constructive receipts**
 - **S 6-5(4) ITAA 97** tells us that 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
 - This means that if you direct your employer to pay you a week later than usual, or to make the payment to your wife instead, it is still as if you have received the income. It is still assessable on you.
 - **RACV v FCT** tells us that refund of club membership fees are not assessable

Question 5: Identify the main three categories which ordinary income usually falls under

- **Category 1: Income from Personal Exertion**

- Income from the taxpayer's ordinary exertion is likely to be ordinary income. This usually includes labour, employment and services.
- **Income for personal services – Brown v FCT**
 - **Brown v FCT**
 - **Facts:** Brown engaged in various activities which led to his success in major property development. On completion, certain units from the property were transferred to him free of charge. Commissioner argued that the money which he derived was income according to ordinary concepts. Taxpayer argued that the money was not a reward for services but was a gift motivated by friendship
 - **Held:** The receipts were a reward for services and therefore were ordinary income. The facts did not support Brown's claim that it was a gift.
- **Income which has a nexus to the income producing activity – Smith v FCT**
 - This case tells us that the key in determining if something is ordinary income or not is to look at if there is a nexus between the income and the producing activity.
- **Income which has been sourced from a third party – Kelly v FCT**
 - **Kelly v FCT** tells us that money can still be income even if it has been sourced from a third party but regarding your employment.
- **Income given in a lump sum – Brent v FCT**
 - This case tells us that as long as the money as properly been characterised as a reward for service, even if the money has been given in a lump sum, it is still deemed as assessable.
- **Restrictive covenant payments**
 - A restricted covenant payment is when you are paid under contract to agree to not do something. For example, being a celebrity and agreeing not to engage in dangerous sports.
 - **Is it income or capital?**
 - This depends on whether or not the money derived is connected to current employment
 - **Higgs v Oliver** tells us that it is capital if it is derived after employment
 - **FCT v Woite** tells us it is income if it is derived during current employment
 - In this case, Woite was paid \$10,000 to not play football with any other club except North Melbourne
- **Unexpected payments received as a reward for service**
 - The case **Laidler v Perry** tells us that unexpected payments, when received as a reward for service, will constitute ordinary income.
- **Tips**
 - Tips are third party voluntary payments received by service providers made in response to the service. Therefore, tips constitute ordinary income.
 - Tips are also often considered as a recognised incident of certain professions, e.g. waitressing
- **Voluntary gift payments – Hayes v FCT, Scott v FCT**
 - **Hayes v FCT**
 - **Facts:** In this case, Hayes derived some income from a friend for services. The two were really good friends. Commissioner argued the money which Hayes derived was income according to ordinary concepts. Taxpayer argued that the money was a gift.
 - **Held:** As they were friends, the Court held that the money derived was a voluntary gift payment and therefore it was not ordinary assessable income.
 - **Scott v FCT**
 - **Facts:** Taxpayer was a solicitor who was engaged in business investments with long-time client Mr Freestone. Mr Freestone died. Taxpayer acted for his now widowed wife in probate and administration of Mr Freestones will. To thank him, the wife directed the taxpayer to pay himself from the will. Commissioner argued the money was assessable. Taxpayer argued it was a gift and not assessable.

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- Gambling on horse racing is more likely to be a business if the gambler is associated with other related activities such as owning horses, training horses or operation as a bookmaker - **IT Ruling 2655**
 - Characteristics of gambling as a business in horse racing includes:
 - The size of the bets - **Trautwein v FCT 1936**
 - The systematic and organised approach - **Trautwein v FCT 1936**
 - Commitment of substantial amounts of money and time to betting; and - **Trautwein v FCT 1936**
 - Employment of other people to place bets & collect winnings - **Trautwein v FCT 1936**
 - The nexus between the gambling and its integration with the horse racing business.
 - **Trautwein Case**
 - **Obiter:** If facts similar to Trautwein were considered by the courts today, the same conclusion may not be reached, because the Courts have generally concluded that gambling does not constitute a business if it is not conducted on a large scale and is not connected to another business - **Martin v FCT 1953; Evans v FCT 1989.**
 - **Martin v FCT**
 - **Held:** In **Martin v FCT**, HC considered the taxpayer's many alternative previous careers and fields of employment in deciding that the taxpayers gambling was recreational and not a business.
 - **Evans v FCT**
 - **Held:** In **Evans v FCT**, FC found that Evans was a lucky gambler and was not conducting a business because of the lack of systematic approach.
 - **Sportsperson**
 - **Supporting indicators**
 - The sportsperson plays team sport at a high level – **Spriggs v FCT; Riddell v FCT**
 - Even more if a supporting indicator if the person also undertakes related commercial activities such as seeking corporate sponsorship – **Stone v FCT**
 - Playing a sport full-time in leagues and having a manager who handles the management side of things can constitute as carrying on a business – **Spriggs v FCT; Riddell v FCT**
 - Motivation does not have to be profit. If the person was employed for their skills to earn income from their sport, it is sufficient to constitute as carrying on of a business – **Stone v FCT**
 - Club fee payments will be considered ordinary income from business
 - Fees paid to manager to enter into a contract with a new team would be deductible – **Spriggs v FCT ; Riddell v FCT**
 - Prizes will be ordinary income from that business – **Stone v FCT**
 - **Exception:**
 - Unless the prize was given for personal qualities rather than professional – **Stone v FCT**
 - **Non supporting indicators**
 - When it can be deemed to be the result of employment rather than business – **Maddalena v FCT**
 - **Maddalena v FCT**

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- **Facts:** In this case, the taxpayer was playing football part time and had no manager.
 - **Held:** The lack of manager made it to be deemed as employment income not business income
 - In this situation, club fee payments would be considered ordinary income from personal exertion
 - **Kelly v FCT** tells us that prizes received for sporting achievement may be regarded as ordinary income from personal services
 - **Investment activities**
 - **Supporting indicators**
 - Large superannuation funds and listed investment trusts are commonly in the business of investment
 - There has to be more than a profit-making intention and frequent transactions to show that the taxpayer is carrying on a business of investing.
 - **AAT Case** tells us that an individual taxpayer trading shares in his own name is considered as being in the business of share trading for income tax purposes
 - In **London Aust Investment v FCT 1977**, the High Court held that a business of investment was being carried on due to the high degree of activity in investing and reinvesting its shares to maintain a minimum dividend yield
 - **AGC Investments v FCT 1992** tells us that if a business conversely, invested for long-term growth rather than speculative investment, then it would be classified as property income and not business income
 - **Land sales**
 - **Supporting indicators**
 - **FCT v St Huberts Island 1978** tells us that where the firms primary activity is purchasing, developing and selling land, it is clearly undertaking an ongoing business of selling land
 - A firm that sells a factory and accompanying land, because the property is no longer required, is clearly not in the business of selling land.
 - **Is the business being “carried on” during the relevant tax period?**
 - **Commencement and termination of business**
 - Transactions that occur before the business commences or after it has ceased are treated differently for tax purposes to those that occur during business operation.
 - **Softwood Pulp v FCT 1976** tells us that the commencement of a business is a question of fact primarily based on the intention of the taxpayer at the relevant point in time.
 - **Preliminary expenses**
 - If the business has not commenced, these expenses will not be deductible under **s 8-1 ITAA 97**, although it may be possible to obtain a deduction under **s 40-880 ITAA 97**
 - **Commitment to commencing a business**
 - **Softwood Pulp 1976 Case** tells us that if a taxpayer commits to commencing a business, then the relevant expenses incurred are deductible. However if the taxpayer is merely “testing the waters” and simply deciding whether or not to go ahead, then the expenses are not deductible.
 - **Softwood Pulp v FCT 1976** tells us that a feasibility study is not considered a commitment to commencing business
 - In **FCT v Osborne**, it was found that business had already commenced, therefore expenses were deductible

- Entering into a lease agreement is a clear indication of commitment.
- **Element 2: Are the receipts in fact the normal proceeds of carrying on that business, and not from some other activity?**
 - **California Syndicate 1904 Case** tells us that if a receipt is not earned from “carrying on” the usual business of the taxpayer, then it is not within the “normal proceeds” of the business.
 - **Step 1: Investigate the nature of the business**
 - **Approach 1: Narrow approach**
 - **FCT v Merv Brown Pty Ltd**
 - **Held:** In this case, it was held that the sale of unwanted import quotas were found as not being proceeds of the business, because the majority identified that the taxpayer’s business was as to the purchase and sale of clothing and material, not of import quotas. Therefore the sale of import quotas was not the normal proceeds of this business activity.
 - **Approach 2: Broad approach**
 - A stronger connection is needed here than under the aforementioned narrow approach
 - **GP International Pipecoaters v FCT 1990**
 - **Held:** In GP International Pipecoaters v FCT 1990, the HC held that the receipt of money to cover the cost of constructing the pipe coating factory was within the normal proceeds of the business because the money was received as a result of work which was required to be carried out due to successfully winning the tender to coat pipes.
 - **Step 2: Assess whether the receipt shows a nexus with the identified business activity**
 - Receipts will be normal business proceeds when they are a product of:
 - A transaction that is part of the ordinary business activity, such as a share trader’s receipts from the sale of shares; or
 - A transaction that is an ordinary incident of the business activities – e.g., the sale of ex-lease goods by a leasing company would in some circumstances be business income - **Memorex Ltd v FCT 1987**
 - Some court decisions suggest that an important consideration here is the frequency & magnitude of the activity that generated the receipt.
 - **Non cash benefits – considered normal proceeds of carrying on business?**
 - **Old position:** **FCT v Cooke and Sherden 1980** tells us that business income will not include amounts that are non-cash business benefits
 - **New position:** **§ 21A ITAA 36** deems non-cash business receipts to be cash convertible and then prescribes a method of valuing the cash benefit.
 - The purpose for this section is to overcome the issue of business receipts being considered as not ordinary income only because it lacks the cash convertibility requirement
 - **How to ascertain if the new position applies**
 - **Element 1:** Is the benefit truly income in nature as a benefit derived from carrying on a business, disregarding whether it is cash or cash convertible? If yes, then apply **§ 21A ITAA 36:**
 - **§ 21A(1) ITAA 36** treats it as convertible to cash, and
 - **§ 21(2) ITAA 36** requires the benefit to be brought to account at its arms-length (market) value, less any amount that the taxpayer contributed to acquiring the benefit
 - **Will an isolated or extraordinary transaction constitute ordinary income?**
 - **Isolated transaction**
 - **Whitford Beach Case** tells us that isolated transactions are one-off transactions not conducted by existing business
 - **Extraordinary transaction**

- **Myer Emporium** tells us that transactions outside normal proceeds of business are “extraordinary transactions” which may or may not constitute business
- Must fall into one of the following three categories to constitute as ordinary income under **s 6-5 ITAA 97**
- **Category 1: The transaction forms a business – Whitfords Beach Case**
 - Applies to isolated transactions only
 - **Element 1:** Does the transaction involve a significant amount of effort, capital and planning? – **Whitford’s Beach Case**
 - **Element 2:** Is the transaction more than mere realisation of an enhanced asset?
 - Only the net profit is assessable under **s 6-5 ITAA 97**
- **Category 2: Falls under the first strand of Myer Emporium**
 - **Element 1:** Was there a business operation or commercial transaction? – **Myer Emporium**
 - **Element 2:** Was there a profit making intention behind that transaction? – **Myer Emporium**
 - **Element 3:** Was the profit actually made the kind intended at the time the transaction was entered into? – **Westfield v FCT; Myer Emporium**
- **Category 3: Falls under the second strand of Myer Emporium**
 - **Element 1:** Did the taxpayer sell the right to income from an asset without selling the underlying asset? – **Myer Emporium**
 - If yes, ordinary income. If no, not ordinary income.
- **If not ordinary income, could it be capital gains?**
 - A post September 1985 transaction that is NOT ordinary income may trigger capital gains tax provisions
 - **Profit from an asset acquired with the purpose for resale**
 - **S 25A ITAA 36** deems such profits statutory income, unless it is a post Sept 1985 asset or resale was not the dominant purpose
- **Category 3: Income from Property**
 - Income from the use or exploitation of property is ordinary income under **s 6-5 ITAA 97**
 - **Sub-Category 1: Rent**
 - The case **Adelaide Fruit and Produce Exchange 1932** tells us that rent is a payment by one party in exchange for the use of the other party’s property for an agreed amount of time, and the receipt of rent by the lessor clearly constitutes ordinary income.
 - Still considered assessable even if paid in lump sum.
 - **Sub-Category 2: Interest**
 - **Riches v Westminster Bank 1947** describes interest as a payment which becomes due because the creditor has not had his money at the due date.
 - **Discounts and premiums**
 - Lenders may increase the standard interest rate to account for the increased risk of non-repayment, or they may retain the standard rate of interest and negotiate a discount or premium on the debt.
 - **Lomax v Peter Dixon 1943** shows us that there is a distinction between interest which is ordinary income and a capital return that results from an allowance of a risk.
 - **Discounted loan**
 - A discounted loan is one where the amount provided to the borrower is less than the amount of the loan.
 - **Loan premium**
 - A loan premium is one where the borrower has to repay more than the amount advanced by the lender.
 - **Timing of interest receipts**

- Interest is usually ordinary income. However, if the receipt of the discounts or premiums is deferred to when the debt is redeemed, this may delay the time when the gain is assessable. If this is the case, it will not be assessable until that later time when the gain is realised – **FCT v AGC 1984; s 6-5(2) ITAA 97**
- **Sub-Category 3: Annuity**
 - An annuity is a stream of payments that occur at regular intervals and this may be for a fixed length of time or for the life of an individual
- **Sub-Category 4: Royalties**
 - The following would constitute as royalties:
 - When a taxpayer is paid for use of his or her intellectual property
 - When the owner of intellectual property agrees to sell his or her intellectual property for an amount based on its usage
 - Where someone is paid to produce intellectual property and the payment is based on its subsequent usage
 - Where a taxpayer is paid for his or her physical resources based on the quantity of the resources taken
- **Sub-Category 5: Dividends**
 - Also specifically made assessable under **s 44 ITAA 36. S 6-25 ITAA 97** tells us that **s 44 ITAA 36** takes priority, therefore it is assessed as statutory income rather than ordinary
 - The payment of a dividend is not considered an expense to the company! It is equity, so it is not deductible

Question 6: Ascertain if the money is likely to be ordinary income or capital (if you are unsure)

- **Lump sum payments**
 - If the lump sum payment is a valuable right, then it is capital
 - **Brent v FCT** tells us that if the lump sum was received as payment for service, then it is ordinary income
- **Payments for changes to employment rights**
 - **Bennett v FCT** tells us that this would make it a capital receipt
- **Sign-on bonuses**
 - **Jarrold v Boustead** tells us that this would make it a capital receipt
 - **Exception**
 - **Ruling TR 1999/17** tells us that if the sign on bonus is a normal practice that is used to attract the right candidate, then it is ordinary income

Question 7: Ascertain if the money, if not ordinary income, can it be considered statutory income?

- **S 15-2 ITAA 97**
 - **S 15-2 ITAA 97** makes the following things statutory income, if it is deemed as not being ordinary income:
 - Allowance, gratuity, compensation, benefit, bonus or premium (not limited to cash or expected payments)
 - It must have been provided to the employee or service provider (**Payne Case**)
 - The gain must have been made in respect of or in relation to employment or provision of service (**Smith v FCT**)
 - **S 15-2 ITAA 97** does not apply to ordinary income or fringe benefits tax (**s 23L ITAA 36**)
 - **S 6-5 ITAA 97** takes priority over **s 15-2 ITAA 97**
- **S 15-3 ITAA 97**
 - This covers return to work payments
 - It makes assessable any amount used to induce taxpayer to return to work
 - It could also be ordinary income
 - **S 6-25 ITAA 97** tells us that **s 15-3 ITAA 97** takes priority over **s 6-5 ITAA 97**.