MLL406
Taxation
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Topic 1: Introduction to tax law

Income Tax Assessment Act 1936 (ITAA 36)

Income Tax Assessment Act 1997 (ITAA 97)

A New Tax System (Goods and Services Tax) Act 1999—This Act deals with the GST.

Fringe Benefits Tax Assessment Act 1986 and other related acts.

Taxation Administration Act 1953 (TAA 1953) – covers taxation objections and appeals (courts etc).
Federal Court and HC only

Income Tax Regulations—These prescribe how certain parts of the principal Act are to be implemented.

Rating Acts (Income Tax Rates Act 1986) — They impose the actual tax on taxable income as determined by the ITAA (amended as required to reflect change).

Crimes (Taxation Offences) Act 1980. E.g. Tax fraud and Part IVA avoidance of tax

1. Introduction to tax law

- Federal jurisdiction, use Commlaw (for most relevant version of the Act) and use Austlii too.

Focus of the unit: The taxation of income in Australia (Federal jurisdiction). NOT State based taxes (e.g. stamp-duty and property)

ASSIGNMENT – 40% - 21 Sept – 2000 words
→ will take the form of problem question (as oppose to an essay style).

EXAM – 60% open book

- Look at Income Tax Assessment Acts (ITAAs)

1. The role of income tax

Relevance of tax: Tax affects the distribution of income in a society and provides parameters within which government spending programs can be maintained
the 2nd equation is the most important * - from Div 4 in the 1997 Act. Assessable income incl statutory income (so CGT as well)

We want to know how much Taxable income is – so that we know how much we have to pay (Tax payable).

It’s important to be able to identify if there will be tax implications from a transaction.

There are constant changes in relation to tax law.

- Tax has a legislative basis only: it doesn’t come from the common law

- Need for tax – no society has ever risen without taxation (Australia’s first tax was imposed in 1800)

NB: The Australian and English tax schemes are not the same so use English case law with caution (FCT v Whitfords Beach P/L)

- Types of taxes: Income Expenditure

- Who pays:

  2013/2014 budget Total tax is $354 billion Individuals: $170 billion GST: $51 billion Pocket tax guide – online

- This unit is concerned with the following relationships:

  1. Tax payable = (Taxable income x tax rate) – tax offsets; and

  2. S 18 ITTA: Taxable income = Assessable income – allowable deductions

2. An overview of tax
What is tax and what are the purposes and effects of tax?

- A tax may be defined as a ‘pecuniary burden laid upon individuals or property to support the government...a payment exacted by legislative authority’ *Black’s Law Dictionary*

- A tax is a financial levy imposed on the individual or a legal entity (company). Companies pay a flat rate of tax of 30%. Individuals pay tax on a sliding scale (marginal tax rate), the more money you make, the more you pay: progressive rate.

- **Tax** = the compulsory exaction of money by a public authority for public purposes that’s enforceable by law (*Matthews v Chicory Marketing Board*)

- There are indirect or direct taxes

- Taxes are not voluntary – they are mandatory contributions

Who is responsible for tax collection?

- The Australian Taxation Office (ATO) does everything administrative

- The funds received from taxes are provided to carry out many government functions (e.g. welfare, health care, pension, public services, schools, operation of the government...)

- The reason that there are many different rates for tax and not one rate that everyone pays, is so that the tax burden can be distributed amongst the population

Qualities to which a tax should aspire

1. A taxation system needs to be **fair/equitable** amongst its citizens. If it is perceived not to be fair, issues can arise such as distrust in the government and tax avoidance. Two key elements:

   - **Horizontal equity** means that people and businesses who are in a similar positions should be treated equally

   - **Vertical equity** means that people who are in different financial positions should be treated differently [e.g. a high income individual should pay more tax than a low income individual. So different marginal rates. We have a tax free threshold of $18,200]

   While in theory horizontal and vertical equity are noble, in practice there may not be as much equity as there’s supposed to be, because with companies that all pay 30% tax, one may make $1billion and the other may make $20k but they still pay at the same rate. Fair?
2. Simplicity:
   o Simplicity of a tax system is determined by two things -
     1. The ease with which a tax payer can comply with the act. The more complex the Tax Act, the harder it is for a tax payer to work out what tax they owe
     2. The authorities ability to administer the act and collect tax

Simplicity is something that the Australian tax system has struggled with – this is why there have been various reforms to try and get some simplicity and consistency throughout the tax system (see below). We have 2 different Tax Acts: **Income Tax Assessment 1936 Act** and **Income Tax Assessment 1997 Act**, so many rules and provisions because the reform of the 1936 Act to simplify it never ended up being completed. Also we have a system of self-assessment (we self assess our tax liability – so we make mistakes often). There is also so much litigation of tax provisions.

Complexity: Issues of complexity arise when parts of the act are obscure or its difficult to decipher the meaning of the words. We have over 2100 of inoperative tax provisions (according to the Board of Taxation), which is why we aimed to reduce the size of the provisions via the **Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (Cth)**. The Acts are still very obscure.

3. Certainty

There are four things within certainty:

1. **Certainty of incidence** – this is the ability for the taxation authorities to predict who will actually bear the tax burden, when they are looking at implementing a new tax or tax system. They also look at the effects it will have. This is important because otherwise we can end up in avoidance of the system and people not trusting it.

2. **Certainty of liability** – This is decided by how easily a taxpayers can determine their liability and how accurate that determination will be. Australia has a self-assessment regime under both Tax Acts. It is hard to have certainty of liability with so many taxes and two tax acts. There are over 135 different taxes

3. **Evasion ratio** – Anticipation of how much tax avoidance there will be and tax evasion are considerations when new taxes are being made

4. **Fiscal marksmanship** – This involves the authorities prediction as to how much tax they think they will get in a particular year. There needs to be a process by which authorities can predict how the implementation of the tax will bring in revenue. This is vital for the budget. But there is a problem here because a lot of the budget measures for infrastructure and schools etc is at a State level, they calculate the requirements. So you can get a lot of disparity from Cth revenue to the States (known as **vertical fiscal imparity**) so that the States can properly implement what they need with enough money.
In Australia, the fiscal year or, more commonly, “financial year”, starts on 1 July and ends on 30 June. For personal income tax after the financial year ends, individuals have until 31 October to lodge their return (unless they use a tax agent).

4. Efficiency

- A taxation system must be administratively efficient – it must be administratively efficient and neutral
- **Administrative efficiency**: taxes should not skew resource allocation across the economy. The cost of administering and complying with the Tax Act should be minimised (e.g. you can lodge from your own home)
- **Neutrality**: Taxes and implementation of taxes should not affect decision making in the marketplace. But this isn’t the case – e.g. we have small business concessions. In practice, however, this doesn’t happen – companies are taxed differently to individuals...the goal of neutrality is ignored.

  e.g. roll over reliefs, doing things to take a certain deduction, accessing a rollover, reducing your taxable income (thus the tax payable).

**Incidence of Tax (ways in which tax can be charged)**

Incidence of tax may be **regressive, proportional or progressive**.

**Regressive**: A tax is regressive if it exacts a lesser proportion of tax the greater the income derived. Under a regressive tax, a taxpayer earns more income that additional income is taxed at a lower rate than initial income receipts. A regressive tax places a proportionate higher tax burden on low-income earners than on high income earners.

**Proportional (flat-rate)**: A proportional tax exacts the same proportion of tax on each dollar of income. Hence, a 15% flat tax on all income will be said to be proportional (15% is the tax that SUPER FUNDS pay). In Australia, companies are taxed at a proportional rate. The current rate of tax for companies is 30 cents in the dollar. As everybody pays the same amount of tax regardless of their income and financial position, flat taxes impose a greater burden on low-income earners.

**Progressive**: In contrast to a regressive tax, a tax is progressive if it exacts a greater proportion of tax on income as it increases. Under a progressive tax system, theoretically, a greater tax burden is placed on high-income earners (BUT THIS IS THEORY- NOT IN PRACTICE- THE RICH PAY LESS TAX THAN THE POOR IN PRACTICE: bc of access to resources, access to tax planning, corporate structures, trust structures: tax minimization). The
Australian taxation system’s treatment of personal income is progressive. SO...is it equality of opportunity (implement a flat rate) or equality of outcome (which is what we have)?

What are the marginal rates?
Tax rates 2015-16

<table>
<thead>
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<th>Taxable income</th>
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<tr>
<td>0 – $18,200</td>
<td>Nil</td>
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<tr>
<td>$18,201 – $37,000</td>
<td>19c for each $1 over $18,200</td>
</tr>
<tr>
<td>$37,001 – $80,000</td>
<td>$3,572 plus 32.5c for each $1 over $37,000</td>
</tr>
<tr>
<td>$80,001 – $180,000</td>
<td>$17,547 plus 37c for each $1 over $80,000</td>
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<tr>
<td>$180,001 and over</td>
<td>$54,547 plus 45c for each $1 over $180,000</td>
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These amounts are not inclusive of Medicare levy (2% taxable income) or Medicare Levy Surcharge

Medicare levy surcharge = 1.5% taxable income

3. Federal taxation

Constitutional basis of taxation

• The Federal government has the power to make laws with respect to taxation via the Constitution (s 51(ii))

**Effect of S 51(ii): The Commonwealth retains the power to legislate on matters of taxation provided the legislation does NOT discriminate (s 99) between States and Territories

No discrimination: There must be uniformity in tax law. This is reinforced by s 99 Constitution which prohibits any law or regulation of trade, commerce or revenue (like tax) giving preference to any state/part of a State. Grants to states under s 96 Constitution aren’t subject to discrimination or preference rules

• S 55 Constitution states: ‘Laws imposing taxation shall deal only with the imposition of taxation; any provision therein dealing with any other matter shall be of no effect.’
• About: Whether the ITTA deals with matters other than taxation o This prevents ‘tacking’ = the process of exploiting constitutional limitations on upper houses’ powers to amend money bills by tacking a tax onto a bill dealing with other matters o This means that federal revenue law is made up of a number of individual Acts directed to particular aspects of assessment and rating o Example: Taxes relating to Medicare are contained in the Medicare Levy Act 1986 (Cth)

o Exception: The taxation of capital gains is incorporated into the ITTA97, instead of separate legislation because it wasn’t drafted as a separate tax (it’s included in assessable income) (Resch)

The States and the Commonwealth + taxation

• Commonwealth and State tax laws are concurrent HOWEVER S 109 Constitution holds that Commonwealth laws prevail in cases of inconsistencies between the two

• Uniform tax legislation: This doesn’t exclude the states from the field of income taxation.

o S 96 Constitution: The power to distribute funds to the states from tax revenue

o Also under the 2000 Federal Government’s Tax Reform Plan, GST collections were to be returned to states in return for them to abolish a range of other taxes and charges

• S 90 Constitution: This gives the Commonwealth the exclusive right to impose duties of custom and excise [STATES CANNOT impose these duties]. But Cth cannot tax State property (hence is why we have stamp-duty etc on property in Vic) and the States cannot tax Cth property.

o Any state law on this power will thus be unconstitutional o The definition of custom and excise (= tax) has been interpreted broadly

• States used to collect their own income taxes, but the Cth aid they would not give the States and of its funding – so that’s why the State gave it up, that’s why the Cth now gives the States allocated funding.
Different types of taxes explained

**Personal income taxes:**
The most significant in this course. Works by a marginal tax rate, system of self-assessment.
Your taxable income = assessable income – deductions. These are progressively imposed in Australia. They are imposed on individuals. High income earners pay more than low income earners

**Corporate taxes:** These are taxes paid on a company’s profits (is 30%). We get franking credits – look at the dividend imputation system in respect of companies.
Dividend = distribution of company profit.

**NON CORPORATE:**
Also look at trust and partnerships (but these do NOT pay tax). The tax is paid by the beneficiary or the trustee (where there is no beneficiary that is presently entitled OR the beneficiary is under a legal disability).
A partnership does NOT pay tax, but the individual partners pay tax at their marginal tax rates (they just include their distribution of the partnership income in their personal tax returns).

**GST:** Introduced in 2000. It’s a 10% tax on the sale of most goods and services in Australia. We deal with credits and a chain of distribution. The tax burden is bared by the consumers. This is because people along the supply chain of the product are entitled to credits for the GST that they have had to pay. So what happens in the end is when we go to the shops and buy the product, we bare that burden. The revenue of GST is distributed down to the states

**Property taxes:**
Local governments are typically funded by property taxes (council rates, land tax rates...)
State governments do levy these taxes

**Excise taxes:**
Both the federal and state governments impose excise taxes on inelastic goods such as cigarettes, petrol, and alcohol.

**Payroll taxes:**
State governments impose payroll taxes at varied rates.

**Inheritance tax:** (we don’t have death taxes, other than in a situation where there is beneficiaries of the estate – here there may be tax implications – also CGT does exist)
There is absolutely no inheritance tax in Australia, although inherited assets may have Capital Gains Tax implications for beneficiaries.

**Superannuation Taxes (15% flat rate where complying concessional contributions):**
Superannuation is taxed at three points:
contributions to funds, on investment income (return on the fund) and on benefits received.

**Fringe Benefit Tax (FBT)**
A fringe benefit is a benefit, other than a salary or wage, derived from employment. Before the introduction of FBT in 1986, most fringe benefits weren’t taxed. FBT applies to non-cash remuneration benefits paid or given by an employer and received by or benefiting an employee (or associate of an employee). It’s a tax on something given to you in the course of your employment but outside of a salary or wage. Example: Some people get cars with their jobs. The EMPLOYER PAYS THE TAX on the Grossed up amount of the taxable fringe benefit!

4. Tax reform and complexity

ITAA 1997: Provisions are separated by a dash ( - ) e.g. 6.5
ITAA 1936: Provisions are separated by a ( . ) e.g. 6.5

- The labour government introduced a lot of new legislation aimed at decreasing the opportunity for tax avoidance and evasion. They added significantly to the Income Tax Assessment Acts (1936) [ITTA] and introduced taxes for capital gains which had previously never been taxed in Australia

- The ITTA 1936 then contained over 1200 sections. It was argued that this made it incomprehensible to the ordinary tax payer. It needed to be simplified

**Basically:** They attempted to reform and simplify the ITTA 1936 although this fundamentally did not work – both acts still apply

- Some of the relevant changes made under post-1985 governments include: o CGT – taxation of capital gains  o GST – introduction of a Goods and Services Tax  o FBT – fringe benefits tax for employee benefits

- **Foreign Tax Credits Schemes** to deal with the foreign income of Australian taxpayers

- **Substantiation requirements** before deductions are allowable  o **Imputation credits** – imputation of tax paid by companies onto the liability

of shareholders to tax on company dividends when received by them o **Superannuation taxes** – special provisions for superannuation funds  o **Entertainment expenses limitations** – limitation of deductions for

entertainment expenditure  o **Tax consolidation rules** for corporate groups  o Thin capitalisation rules that are concerned with characterisation of debt as

equity for tax purposes  o **Small business simplification rules** - The legislation is also being expanded by

‘simplification rules’ which are aimed at reducing time required to comply

with the legislation  o **PAYG** reporting of individual taxation – Pay-As-You-Go and quarterly reporting of tax

- Despite all these changes, **disputes continue to arise** and there is a continual stream of rulings, cases and reform proposals
The Henry Review 2010 – the ‘root and branch’ approach:
The first major review of taxation in Australia was undertaken by John Ralph and was known as the ‘Tax Law Improvement Project’ or TLIP. **TLIP’s task:** Restructure, re-number and simplify the Income Tax Act by rewriting it in plain language

- Many of the changes recommended in that review were implemented, however, not all and in 2010 Ken Henry was hired to perform another major review of taxation in Australia

- ‘Australia’s Future Tax System’ came with a lot of recommendations again, including the abolition of CGT, reproduction of personal income taxes (including a simplified reporting system for taxpayers who earned under the threshold) and changes to business taxes

  - Many, but not all of these changes were implemented • The government continues to introduce taxation legislation on a very regular basis, with both major parties having significant cultural differences on what they see as the role of taxation you can expect changes to occur dramatically as the federal government changes hands

5. Income Tax Assessment Act + relevant legislation

- The Income Tax Assessment Act is the sole income taxing authority in Australia. A number of states challenged this

- **The ITTA 1936 and ITTA 1997 are both operative alongside each other – each deal with different aspects of the income tax

- This was tested by the High Court in the case of Resch v FCT (1942) 66 CLR 198 where the court decided that matters such as the valuation of stock in trade, capitalised profits and lease premiums did not deal with matter ‘other than taxation’

  - This challenge failed

- **There have been numerous High Court challenges to taxation laws over the years by States, individuals and companies – so far the court has upheld the Federal Government’s constitutional right to make laws with respect to taxation and allowed a broad-brush approach to how it does that.

- **Victoria & Anor v Commonwealth (1957): The States partly succeeded in their attack on the Commonwealth’s uniform tax legislation, but they were unable to prevent the Commonwealth from being the sole body responsible for levying income tax

- For the majority of this course we will be dealing with the two ITAA’s:

  - Income Tax Assessment Act 1936: The original Act that is now gradually
being replaced by the ITTA 1997. This Act doesn’t impose an income tax, but determines taxable income. **Income Tax Assessment Act 1997**: the majority of our legislation is found in a newer version of the act, however a substantial amount of our case law refers to the old Act, thus we need both. **The means of determining income tax** is solely contained in the ITTA1936. Liability is a function of legislation and depends upon the wording of this legislation and they way it would be interpreted by the courts if necessary.

6

Other relevant regulations and legislation

**Income Tax Assessment Act 1936 (ITAA 36)**

**Income Tax Assessment Act 1997 (ITAA 97)**

A New Tax System (Goods and Services Tax) Act 1999—This Act deals with the GST.

Fringe Benefits Tax Assessment Act 1986 and other related acts.

Taxation Administration Act 1953 (TAA 1953) – covers taxation objections and appeals (courts etc).

Federal Court and HC only)

Income Tax Regulations—These prescribe how certain parts of the principal Act are to be implemented.

Rating Acts (Income Tax Rates Act 1986)—They impose the actual tax on taxable income as determined by the ITAA (amended as required to reflect change).

Crimes (Taxation Offences) Act 1980. E.g. Tax fraud and Part IVA avoidance of tax

With the ITAA’s there comes substantial related acts, such as the Ratings Acts which impose the annual tax rates, the Administrative Acts which impose rules with respect to substantiation, timing of tax returns and other forms

**Income Tax Regulations**: these prescribe how certain parts of the principle Act are to be implemented

**Ratings Acts**: these Acts are re-enacted each financial year, or as required. They impose the actual tax on taxable income as determined by the ITTA

**Income Tax (International Agreements) Act 1953**: this Act deals with tax treaties aimed at
preventing double taxation and encouraging cooperation between Australia and overseas
tax authorities in enforcing their respective tax laws

- **Tax Administration Act 1953** and **Tax Administration Regulations**
- **Crimes (Taxation Offences) Act 1980**
- **Taxation (Unpaid Company Tax) Assessment Act 1982** and other related acts

- We also deal with:
  - **Fringe Benefits Tax Assessment Act 1986** and other related acts
  - **A New Tax System (Goods and Services Tax) Act 1999**: This Act deals with

the GST

**How to use the Acts and Precedent**

- For use of the Acts – see Lidia’s power point
- For precedent we follow the familiar route:

  - Australian High Court cases first in descending order (ie 2014 is more relevant than 1930)
  - Australian Federal Court decisions with the full bench
  - Australian Federal Court decisions of a single judge
  - The Administrative Appeals Tribunal
  - External decisions that have been brought into Australian law by reference through the courts

  Example: The ‘Business Entity Test’ is used in Topic 4 to decide when an expense is capital or deductible. This test was born from two major decisions in the House of Lords which his honours reference. Thus it may be relevant to also reference those cases

  It is NOT necessary to hunt through UK, Canadian or NZ law reports looking for alternative precedents—confine yourself to Australian law and only those few cases that the High Court itself have used to determine Australian law

- You will often find that in practise, many matters **stop at a tribunal level**, both for matters of cost and because often a tax payer or the Commissioner will be seeking a specific ruling on a definition which both parties will be satisfied with. **Focus of this course**

**Statutory interpretation**

- **Main sources of tax law**: Statutes and the relating court decisions
- **Maxims**: Three traditional principles for the interpretation of a statute –

  - **Literal rule**: Words are given their literal meaning – their ordinary, natural meaning
Golden rule: The ordinary meaning of the words should be followed, unless this leads to an absurdity or inconsistency

Mischief rule: This seeks to identify the mischief and defect of the earlier law that the new law attempts to remedy

- The above three rules proceed on the assumption that the imposition of tax must be clear and unambiguous

There can be NO tax by implication or inference

Interpretation Act 1901 (Cth): This Act has directed a more purposive interpretation, than a strict, literal approach

Literal approach: Operates on the understanding that parliament’s intention is adequately expressed in the words of the statute and that it is not up to the courts to infer meanings contrary to parliament’s intent

The golden rule is an exception to this rule

Purposive approach: Even if the words of the Act are clear, an interpretation that promotes the purpose of the statute should be preferred over one that does not (FCT v Cripps & Jones Holdings P/L)

Purposive approach is preferred (s 15AA Interpretation Act (Cth))

5. General structure of the ITTA

ITTA 97: Divisions 2 to 4 provide an overview of the structure of the new Act and explain the core purpose of the Act as the determination of taxable income

The following steps describe the basic procedure for determining the income tax due on taxable income as set out in the ITTA 97:

1. Div 4-1: who must pay tax?
Individuals and legal entities (+ some other entities e.g. Super funds)
Australian residents pay tax on ALL sources of income, foreign residents pay
tax on income earned from Australia.

2. **Div 4-10:** Tax is paid each year ending 30 June

Tax payable is based on \((\text{taxable income} \times \text{tax rate}) - \text{tax offsets}\):

3. **Do this first****Div 4-15:** Taxable income is calculated from assessable income
and deductions

   Taxable income = assessable income less deductions

4. **Div 6-1:** Assessable income is classified into *ordinary income* (Div 6-5, which is
   derived from the cases) and *statutory income* (Div 6-10, derived from the
   ITAA). It does NOT include amounts that are neither ordinary or statutory
   income (Div 6-15) nor exempt income (Div 6-20)

   Ordinary income = wages (personal exertion/services), interests from saving,
   property (rent), shares, regular and expected amounts (not normally once
   off)

   Once off money you get, money that is not expected is usually NOT
   ASSESSABLE = DON’T PAY TAX ON IT bc it is not ordinary income.

   Statutory income = CGT

5. **Div 8:** Deductions are classified into *general deductions* (Div 8-1) and *specific
deductions* (Div 8-5). In addition, some expenses are excluded from
deductibility altogether

   - The **below figure** illustrates the structure of how ITTA 97 determines tax liability:
South Australia & Ors v Commonwealth & Ors (1942)

**Fact summary:**
- South Australia’s legal representatives attempted to rely on Parliamentary speeches, reports of committee meetings, etc. This was put as evidence to prove that the 1942 uniform tax legislation was a scheme compelling each State to relinquish their right to impose income tax.

**Held:**
- South Australia’s argument was rejected as being evidence based on extraneous material and NOT relevant to interpreting Parliament’s intentions.
- In an attempt to allow the courts to consider material apart from the Act, an amendment was made to the *Acts Interpretations Act 1901 s 15AB*.

- **Assessable income** in Australia is generally taxed by the Australian government, however due to International Taxation Agreements and Treaties which prevent
the double-taxation of a single income amount, we need to work out which is taxed in Australia and which is not

Example: If Joy, an Australian resident who lives and works in Australia, has an investment property in New Zealand from which she derives income – she should not pay income tax in both New Zealand and Australia for those earnings

Example 2: If Joy, a visitor to Australia for a one month contract to work, lives and works in New Zealand usually, she should not pay income tax for that one month’s work in both countries

The issue of residence or source are complex – particularly with people who may work in several countries over the course of a year and thus fail a residence test in all of them

Similarly, a business being carried out on a multi-national level will have a home but many different sources of income – it is thus important that Australian companies do not have a loophole to shift their business to another country while continuing to earn income in Australia without paying appropriate tax

Residence of the taxpayer

A taxpayer will be a resident of Australia for taxation purposes if they live and work in Australia for more than 6 months of the year (s 6-5(2) + (3) ITTA 1997)

They will also be a resident if they live and study in Australia for more than 6 months of the year

International issues: The Australian tax system initially tries to tax the international income of Australian residents and the Australian income of non-residents

If you are a resident of Australia for tax purposes, then ALL your income from all sources is taxed in Australia, unless one of the exemptions apply (these differ based on the country the other source is from and our treaty with it)

If you are not a resident of Australia for tax purposes, then only income that has an Australian source is taxed in Australia (s 6-10(5) ITTA 1997)

Thus – the two key questions are in the determination of assessable income:

1. Is the taxpayer a resident of Australia?

2. If not, is the source of this taxpayer’s income Australian?

Residence of individuals

S 995-1 – Australian resident: Has the same meaning as that given in s 6(1) ITAA 36 and two elements to the definition:

1. A resident is any person who resides in Australia 
   need to determine what it means, in ordinary concepts, to reside in Australia

2. If they do not reside in Australia, are they included in the definition of a resident under the statutory inclusions in paragraphs (i), (ii) and (iii)?
⇒ This element only applies if the taxpayer isn’t a resident in ordinary concepts

SOURCE:
Source - international status of the ITAA’s is NOT assessable  • The concept of source was explained by Isaacs J in Nathan v FCT (1918):
   • “The legislature in using the word ‘source’ meant, not a legal concept, but something which a practical man would regard as a real source of income… But the ascertainment of the actual source of a given income is a practical, hard matter of fact.”

  • S 6-5 and 60-10: A resident taxpayer must pay tax on income from all sources, whilst a non-resident need only pay Australian tax on income with an Australian source

Some examples of income that has an Australian source can be:

• Personal exertion income: generally regarded as being the place where the work was performed (FCT v French)  o Business income if the business has an Australian source: business income is generally where the business was carried on (C of T (NSW) v Hillsdon Watts)

• Royalties earned in Australia (for example mining royalties): generally the place where the contract was entered into (FCT v United Aircraft Corp)

• Statutory and ordinary interest earned in Australia (for example from a loan given in Australia)

• Dividends paid from an Australian company (where the company has earned the income in Australia or mainly in Australia): dividends are sourced where the company paying the dividend made its profits (Esquire Nominees Ltd v FCT)

Key abbreviations

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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>AAT</td>
<td>Administrative Appeals Tribunal</td>
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<td>AC</td>
<td>Appeals Court (indicates an English decision)</td>
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<td>ADF</td>
<td>Approved Deposit Funds</td>
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<td>AITR</td>
<td>Australian Income Tax Reports</td>
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TOPIC 2: ASSESSABLE INCOME

1. INTRODUCTION

- Topic 1: Assessable income is one of the main components used to determine taxable income & therefore the determination of assessable income is central to the income tax system. Assessable income isn’t specifically defined in the ITAA 97, but s 6-1 gives a representation of the components that make up assessable income
- S 6-1 - Assessable income consists of ordinary income & statutory income.
  - Some ordinary income, & statutory income, is exempt income.
  - Exempt income is NOT assessable income.
  - It doesn’t include exempt income & amounts that are neither assessable nor exempt.
- Division 6 defines each of the above components of assessable income.
  - Ordinary income (s 6-5), statutory income (s 6-10), s 6-15 defines non assessable income & s 6-20 defines exempt income
    - If you don’t have ordinary income under s 6-5 look at the statutory provisions (eg s 15-2, 20 + 20A...)
  - Some amounts will fall into the category of both ordinary income & statutory income - this amount is not counted twice – usually the statute will prevail (therefore it’s statutory income & not ordinary income)

THE INCOME TAX EQUATION
Income tax = (Taxable income x Rate) – Tax Offsets

2. ORDINARY INCOME

- S 6-5(1): defines ordinary income as ‘income according to ordinary concepts’.
  - Because the ITAA doesn’t define ‘income according to ordinary concepts’
any further, you have to look at all the *indicia (propositions)* of ordinary income that have been developed by the courts.

- The courts haven’t developed an explicit definition, but rather identified characteristics which they say are attributable to receipts that are income in nature.

### S 6-5 Income according to ordinary concepts (ordinary income)

(1) Your *assessable income* includes income according to ordinary concepts, which is called *ordinary income*.

Note: Some of the provisions about assessable income listed in section 10-5 may affect the treatment of ordinary income.

(2) If you are an *Australian* resident, your assessable income includes the *ordinary income* you *derived* directly or indirectly from all sources, whether in or out of *Australia*, during the income year.

(3) If you are a foreign resident, your assessable income includes:

   a. the *ordinary income* you *derived* directly or indirectly from all *Australian* sources during the income year; and
   b. other *ordinary income* that a provision includes in your *assessable income* for the income year on some basis other than having an *Australian* source.

(4) In working out whether you have *derived* an amount of *ordinary income*, and (if so) when you *derived* it, 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.

- **Another definition** (Jordan CJ – *SCOTT V COMMISSIONER OF TAXATION (1935)*): Defines ordinary income as ‘receipts that ought to be treated as income must be determined in accordance with the *ordinary concepts & usages of mankind*’.

- Case law has indicated that income for tax purposes does not follow an accounting or economic definition but take it normal very day meaning.

- Over the years this judicial concept of income has identified certain prerequisites and characteristics.

- The prerequisites are necessary but not sufficient conditions for an item to constitute ordinary income. Specifically, the prerequisites are:
  - That the gain must either be *cash or cash convertible*: *FEDERAL COKE CO. PTY LTD V. FCT (1977)*; &
  - That there must be a real gain: *HOCHSTRASSER V. MAYES [1960]*. This prerequisite is mostly applied to employment situations.

- **Ordinary income has certain characteristics** – these traits make it more likely that an item is ordinary income.
  - A gain that is *regular/periodic* is more likely to be ordinary income, than a lump sum.
  - If something ‘flows’ it is more likely to be ordinary income. Courts have used analogies with fruits & trees to illustrate this concept: *EISNER V MACOMBER (1920)*.
    - For instance, the sale of a business is the sale of the ‘tree’, so the gain is likely to be capital & not ordinary income.
    - In contrast, everyday profits from the business are the ‘fruits’ that flow from the business tree & so are likely to constitute ordinary income.
    - Income will flow from capital: capital being the underlying thing which gives rise to income.
      - Eg. income from a rental property
      - capital asset = the house = the tree (income: the fruit flows from it and that’s the rent)
      - Eg. right to work is a capital asset
      - the individual = the tree; salary and wages = fruit and it flows

### 3. PROPOSITIONS THAT ASSIST IN IDENTIFYING ORDINARY INCOME
The following are indicia (characteristics) of income - the characterisation of a receipt as income or not is examined through applying these factors.

**ALL of these propositions** should be considered when s 6-5 potentially applies to a particular set of facts.

- Many will standalone (such as income from property, compensation and the doctrine of mutuality).
- The 12 propositions as to whether an amount constitutes a 6-5 ordinary income & therefore assessable income.

- The main idea is to identify *which of these propositions* (it can be more than one) will help you determine whether *a receipt is income or not*.

- Balance these indicia against each other

**THE NEGATIVE INDICATORS**: elaborated below – NOTE that many items excluded from ordinary income under the negative propositions are now dealt with by specific provisions.

1. Receipts that are not cash or convertible into cash are not ordinary income.
2. Capital receipts are not ordinary income.
3. Personal gifts are not ordinary income.
4. Prize and gambling winnings are not ordinary income.
5. Doctrine of mutuality: Mutual receipts are not income.

**THE POSITIVE INDICATORS**: elaborated below

6. Ordinary income comes in to the recipient.
7. The amount must be characterised as ordinary income in the hands of the person who derived it.
8. Income is more likely to be regular than a once-off.
9. The receipt has a sufficient nexus with an earning activity: income from personal services.
10. Income is earned from the carrying on of a business.
11. Income from property is ordinary income.
12. Compensation for lost income is ordinary income.

**SUMMARY OF INDICIA OF ORDINARY INCOME**

<table>
<thead>
<tr>
<th>Negative Indicia</th>
<th>Positive Indicia</th>
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<tbody>
<tr>
<td>• Not the disposal of capital</td>
<td>• A gain from the use of capital</td>
</tr>
<tr>
<td>• Not a hobby</td>
<td>• Earned from business activities</td>
</tr>
<tr>
<td>• Not a mere realisation of capital</td>
<td>• A once-off transaction with the intention to profit</td>
</tr>
<tr>
<td>• Not a windfall gain or personal gift</td>
<td>• Earned from personal services</td>
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<tr>
<td>• Less likely if a once-off</td>
<td>• Regular or periodically</td>
</tr>
<tr>
<td>• Not compensation for capital loss</td>
<td>• Compensation for lost income</td>
</tr>
<tr>
<td>• Not non-cash benefits or benefits that can’t be converted into cash</td>
<td>• A benefit in the form of cash or convertible into cash</td>
</tr>
<tr>
<td>• Not a mutual receipt or an unrealised gain</td>
<td>• Real gain beneficially derived</td>
</tr>
</tbody>
</table>

**THE NEGATIVE INDICATORS**
1. Receipts that are not cash or convertible into cash are not ordinary income (this is a prerequisite)

- The ordinary meaning of income contains a notion of gain that is money or convertible to money.
- The implication is that if some goods or services are received that cannot be converted to cash then there is no benefit to the taxpayer & therefore no ordinary income.
  - Principle discussed in *FCT v Cooke and Sherden*:
    - Held: amounts that cannot be converted to cash are not in the income in ordinary concepts, & s 21 of the Act could not give a money value where the non-monetary consideration could not be converted into cash or the right transferred to a third party.
    - Therefore benefit(s) [eg free holidays] that can’t be converted to cash are **NOT ordinary income**.
    - However it can be assessable under other provisions.

- If not OI, it won’t form part of assessable income or taxable income so you won’t pay tax on it.
- **INITIAL TEST - Prerequisites** are necessary, but not sufficient conditions, for an item to constitute ordinary income. In order for a payment to be considered ordinary income, it must first pass these two tests:
  a. **The gain must be either cash or cash convertible** (*Federal Coke Co v FCT*);
     - Just because something **IS** cash or cash-convertible, doesn’t automatically make it ordinary income □ □ it just means it could be.
     - On the other hand, if it is **NOT** cash or convertible, it cannot be ordinary income.
  b. There must be **a real gain to the taxpayer** - this is mainly applied to employment situations: *Hochstrasser v Mayes*.
    - Just because there **IS** real gain, doesn’t mean it will become income – it just means it could be income.
    - However, if there is **NO** gain, there cannot be income.

  If the answer is **NO** to one of these tests – then it is **NOT** income & you can go on to consider whether it is capital or something else.

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**Hochstrasser v Mayes 1960**

Precedent for the prerequisite of real gain. Reimbursement for work-related loss when moving = Not assessable, not a real gain.

**Fact Summary**

- TP’s employer required him to move cities
- TP sold his house in city he was leaving and received less than he had paid for it. The employer reimbursed him for the loss.

**Held**

- NOT assessable
- It was not a real gain because he had just been compensated for work related expense = not a real gain = not OI.
- What if it was not work related? Receipt then would have been a real gain.

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**FCT v Cooke & Sherden (1980)**

Amounts that cannot be converted to cash are **NOT** income in ordinary concepts
### Fact Summary
- The taxpayer received a holiday from a business associate as a result of selling a certain number of drinks—the holiday could only be used by the taxpayer or her permitted nominee.
- The tickets were non-transferrable & if sold, were subject to cancellation.
- The ATO sought to tax taxpayers in a soft drink delivery business on the amount of holidays they took.

### Held (on appeal): the free holidays weren’t convertible so couldn’t be classified as ordinary income.
- If the taxpayer receives a benefit, which CANNOT be turned into a pecuniary amount (money), he hasn’t received income according to the ordinary concept of usage.
- **Free holidays** provided manufacturers a cost with a *non-convertible benefit*.
- Followed the principle in the case of *Tennant v Smith* that because holidays not cash convertible could not be OI.
- In *Tennant v Smith* the TP was an agent for a bank & lived in free accommodation supplied by the bank. The TP was not allowed to sublet the accommodation. Neither cash nor cash convertible. Not OI.

### Payne v FCT
**Tickets weren’t convertible to cash so could not be classified as ordinary income**

**Fact summary:** Reward tickets from frequent flyer points could only be used by the taxpayer or her permitted nominee. The tickets weren’t transferrable and if sold, they were subject to cancellation.

**Held:** The tickets were therefore not convertible into cash & so couldn’t be classified as ordinary income.

### 2. Capital receipts are not ordinary income
- As a general principal capital receipts do not constitute OI. (May have CGT consequences however).
- Income arises from the use of capital but *does not include gains* made on the realisation of capital items.
  - Income and capital are treated differently thus it is important to differentiate between capital and income.
  - Property acquired after 19 September 1985 is subject to tax on any gain realized on sale, capital gains tax.
  - (that’s the tree analogy again. Income - the fruit, flows from the tree if you sell that underlying asset.)
- **Generally** capital flows & capital gains (profits on the disposal of capital assets) are not ordinary income - however they may be taxed under capital gains.
- **Capital receipts** may be the result of the sale of a capital asset (eg the sale of property, the sale of a business or the result of a personal services restrictive covenant).
- **Intention of the taxpayer:** Another key aspect of the distinction between capital and income.
  - **Income:** Where the item sold was acquired for the purpose of sale (eg trading