Income Taxation in Australia

Principles of Income, Deductibility and Tax Accounting

by Professor of Law, University of Sydney

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Preface

This Volume sets out to make a close examination of principles of income, deductibility and tax accounting under the *Income Tax Assessment Act* 1936. It may be said to be concerned primarily with what might be called general income tax law developed by the courts around the words “income”, “losses and outgoings”, “derived” and “incurred”. It seeks to express principles as an integrated system. Where judicial decisions have departed from these principles, a need for reconsideration of the decisions is asserted. The security of the income tax against avoidance—the non-payment of tax where the policy of the law would require it—is dependent on the integrity of its principles. Where they can be discerned, the policies of the law are identified and evaluated.

At the same time the Volume deals with all specific provisions of the Assessment Act concerned with income, deductibility and tax accounting, save those that relate to special industries such as mining. It considers the interpretation of those provisions and their relationship with the general tax law. In the result the Volume is a treatise on the law which may be useful to students and in which the tax adviser may find a means of entry to the examination of the law bearing on a tax problem.

The Volume does not attempt a close examination of provisions concerned with the treatment of income moving through intermediaries. Consideration is however given to the correlations of the trust and partnership provisions and the provisions in regard to company distributions, with the general provisions in regard to income deductibility and tax accounting. The function of the trust and partnership provisions is explained in appropriate contexts and there is an account of the taxation of company distributions.

A detailed treatment of the income tax law in regard to income moving through intermediaries is proposed in a further volume in joint authorship with colleagues. At longer range we also have in mind other volumes that will deal with international aspects of the income tax, with the income taxation of special industries and with tax procedure.

The Volume is the outcome of research in and teaching of income tax law over a long period during which I have accumulated debts to many people for ideas and insights about the analytical structure of the income tax law and its policies. My debts are owed to many students, members of the legal and accounting professions and colleagues. My experience as a member of the Asprey Committee left me greatly indebted to his Honour Mr Justice Asprey, to David Butt, Sir Peter Lloyd and Kenneth Wood, and to Alan Boxer, the Committee's Chief Economist. I must express my thanks to their Honours Sir Nigel Bowen, Chief Judge of the Federal Court, Mr Justice Fox of the same Court, Mr Justice Mahoney of the New South Wales Court of Appeal, and to Neville Challoner. They gave the lectures in a series on income tax at Sydney Law School that began the activities of the Committee for Post Graduate Studies in the Department of Law. They have been
followed by many others who have given great service to the School by lecturing in the programmes of lectures arranged by the Committee. I express my thanks to them for their contributions to professional legal education and to my own.

I am very much in the debt of Ash Wheatcroft, the pioneer of legal scholarship in tax in the United Kingdom, who inspired my interest in tax law as a field of legal scholarship. And I am equally in the debt of Willard Pedrick, a leading United States tax lawyer who has earned himself a special place in the affections of Australian lawyers. Among my colleagues over the years I owe special debts to Gerald Kenneally, Graham Hill, Tom Magney and Richard Vann. Gerald and I began the teaching of income tax law in the Master of Laws curriculum. Tom Magney took over for a number of years the teaching of the course in international tax, and that task has now fallen to Richard Vann, a leader in the new generation of tax lawyers.

I acknowledge with gratitude the work of Jennifer Littman, my secretary, who has assumed a vital role in the administration of the Law School's tax programme. She typed the whole of the manuscript of the Volume from my own, barely legible, handwriting. She prepared the table of cases. My thanks are also due to Michael Christie who, as research assistant, made valuable contributions in research and critique and corrected many imperfections.

I acknowledge the assistance of the Australian Research Grants Scheme which provided funds that made possible the appointment of a research assistant. And I acknowledge the opportunities for research and writing provided by my University.

R. W. PARSONS
Addendum

The Assessment Act in its provisions covered in this Volume is the Act as at 1 January 1985. The case law considered embraces reported decisions up to 1 January 1985.

Since 1 January the Act has been amended in some relevant respects by the *Taxation Laws Amendment Act* 1985. The amendments are few and not fundamental, but attention should be drawn to them. More significant are amendments foreshadowed by Government announcements, the one in late 1984 and the other in early 1985, which have not yet been expressed in a Bill. As foreshadowed these amendments will deal with deferred interest securities, securities issued at a discount and indexed capital securities, both in respect of the income character of any gain derived and the deductibility of any loss or outgoing incurred. They will also deal with what might be called business fringe benefits. Some attention should be drawn to the possible implications of such amendments if they come to be made.

More significant again are amendments foreshadowed in the Government's preferred option in its White Paper of 4 June 1985, which include the taxing of capital gains and a new approach to the taxing of fringe benefits. An account of these proposals is not attempted in this addendum.

The 1985 judicial decisions involve some new applications of existing principles, though in some respects the formulation and application of principles might be questioned. Attention should be drawn to them.

**The Taxation Laws Amendment ACT 1985**

The *Taxation Laws Amendment Act* 1985 makes a number of amendments to the provisions of the Assessment Act concerned with the taxation of life assurance companies and superannuation funds. The amendments are all directed to the repeal of what might be called the 30/20 requirement which, if not observed, involved unfavourable tax consequences for life assurance companies and some superannuation funds.

The 30/20 requirement imposed an obligation to hold 30 per cent of assets in public securities, including 20 per cent in Commonwealth securities. The repeal of the requirement involves the repeal of s. 121C, a section referred to in [1.16], and consequential amendments to s. 26AF, referred to in [4.164] and [11.158, 159], to s. 121CA referred to in [1.3, 17] and [4.174] and to s. 82AAS referred to in [4.143, 157] and [10.113-116]; the repeal of s. 121D referred to in [1.3, 23] and [4.93, 174], and consequential amendments to s. 121DA referred to in [1.3, 20] and [4.157, 174, 178] and to s. 121DAB referred to in [1.3, 19, 20, 21] and [4.93, 174]; and the repeal of s. 121DE.

Section 26AFA has been amended to remove the reference in s. 26AFA(1) to s.
Amendments have been made to s. 82KH to extend the operation of s. 82KL by extensions to the definitions of “relevant expenditure” and “eligible relevant expenditure”. The extensions are concerned with deductions under certain expenditure recoupment schemes incurred after 24 September 1978, but will not apply to deductions under schemes entered into after 27 May 1981. From that date the schemes are left to the possible operation of Pt IVA. The extensions to the operation of s. 82KL relate to schemes to exploit deductibility under Div. 10B of Pt III, or the general provisions of s. 51(1). Sections 82KH and 82KL are considered in a number of places in the text, more especially in [10.330-343] and [16.11, 13]. Section 80(5) has been amended so as to deny loss carry forward in respect of losses that arise from deductions under schemes of the kind to which the new provisions of s. 82KH refer, that were entered into on or before 24 September 1978. Section 80(5) is considered in [10.374].

The *Taxation Laws Amendment Act 1985* includes provisions amending Div. 1A of Pt III to remove Christmas Island from the scope of that Division. Subject to some transitional provisions, Christmas Island has become part of mainland Australia for all purposes of the income tax law. The new provisions are in s. 24BA. Division 1A is considered in [1.24, 25].

**Amendments Foreshadowed in Government Statements**

**Deferred interest securities, securities issued at a discount and indexed capital securities**

Amendments foreshadowed by the Government statement in late 1984 relate to deferred interest securities, securities issued at a discount (including so-called DINGO bonds) and indexed capital securities issued after 17 December 1984. The statement (CCH Australian Federal Tax Reporter, para. 98-840) makes the assumption that “under existing income tax law the gain to an investor from holding [such] securities (i.e. the difference between purchase price and the amount received at sale or maturity) is income, akin to interest”, and observes that “[the gain] is taxed at redemption/maturity of the instrument”. This assumption underlies the provisions of s. 23J and is discussed, in connection with that section, in [2.295, 296] and [12.214], and, more generally, in [6.313] and [11.252-258]. The foreshadowed changes in the law are thus explained in the statement:

“The investor's assessable income in any year will include, in addition to any actual interest receipt, an amount equal to the increase during the year in the value of the security. The first step is to calculate the increase in value between successive anniversaries of the date of issue. That increase is derived by calculating the annual yield to maturity (on the basis of compounding on each anniversary of the date of issue), applying that rate to the value of the security a year earlier, and deducting any actual interest receipts during the year from the investment. Within each year the increase will be pro-rated on a daily basis.
In the case of zero-interest securities (including DINGO bonds and similar securities), the compound rate of yield for the foregoing calculation can be determined from the issue price and redemption value; otherwise actual interest receipts must also be taken into account.

In the case of indexed securities of the ‘indexed capital’ type (i.e. where the capital is increased each year in proportion to a specified index until maturity, and a specified interest rate is applied each year to the amount to which the capital is so far indexed), the assessable income of the investor in any year will include the increase by indexation in the capital value as well as the actual interest receipt.

Where the securities concerned are liabilities of a company or other taxable entity, it will be allowed deductions each year calculated on the same basis as assessable income of the investors in the securities.

It is not proposed to apply the new rules where:

the maturity date of the security is a year or less from its date of issue; or
the difference between the issue price of the security and the amount to be paid on redemption, for each year in the term of the security, is 1.5 per cent of the redemption price or less.

If the original holder of a security to which the new rules apply sells it before it matures, the arrangements will be:

for the purpose of determining the accruing income of the new holder, compounding at the original yield will continue from the compounded amount reached at the date of sale; and

if the sale price differs from the compounded amount at the date of sale, the difference will be assessable income to one of the parties in the year of sale and deductible to the other party.

In determining the taxable income of the issuer of securities such as DINGO bonds (under which entitlements to principal or interest on underlying securities are separately marketed), the purchase price of the underlying securities will be allocated between entitlements to principal and interest (whether the entitlements are sold or unsold) according to the fair market values of the entitlements. The part of the purchase price so allocated to a particular entitlement will be deductible only against proceeds from the sale of that entitlement.”

The statement also includes the observations that “under the present law the investor is not taxed on the deferred interest until he receives it at maturity, but there has been a Federal Court decision (F.C. of T. v. Australian Guarantee Corporation Ltd) that the issuer may be allowed a deduction of the interest as it accrues throughout the life of the security, even though the interest is not payable until maturity”, and that “The same position could follow with discounted securities”. Implicit in these observations is some questioning of the Federal Court decision. In fact, the Commissioner sought and obtained special leave to appeal to the High Court in that case, but the leave was subsequently rescinded, possibly
because of the foreshadowing of amendments to the Act in the statement. *Australian Guarantee* (1984) 84 A.T.C. 4642 is discussed in [11.116-121] and in other contexts, where it is regarded as reflecting an important development in general principles of tax accounting.

The foreshadowed amendments will abandon, where they apply, the principle of tax accounting that a gain to be income must be realised—a principle considered in [12.59-72]. They will treat a gain as income as it “accrues”, in a sense of that word that is otherwise irrelevant in tax accounting. They will treat as income an unrealised increase in the value of an asset.

The foreshadowed amendments will, it seems, apply only where a bond has been issued at a discount. Where a bond that carries a low rate of interest compared with current commercial rates is purchased at a discount, any income derivation by the holder will be deferred until the time of redemption or his sale of the bond. Whether there is income at that time will depend on the correctness of the assumption that the excess of the amount realised over cost, where the bond is not a revenue asset and s. 25A is not applicable, is “in the nature of interest”.

**Business fringe benefits**

The foreshadowed amendments to overcome the decision in *Cooke and Sherden* (1980) 80 A.T.C. 4140 are the subject of a statement of 4 February 1985 (C.C.H. Federal Tax Reporter, New Developments, para. 98-858). The amendments will include in the income of the purchaser who receives an otherwise tax free benefit from a supplier, the amount that the benefit would have cost the purchaser in an arm's length transaction. The amendments will apply to benefits given or granted after 4 February 1985. Where a benefit granted to the purchaser is made available to an ordinary employee of the business “the taxation treatment in the hands of the employee will continue to be determined under the existing income tax law”, presumably s. 26(e).

**The Judicial Decisions**

Two new Federal Court decisions are *Lau* (1984) 84 A.T.C. 4929 and *Merv Brown Pty Ltd* (1985) 85 A.T.C. 4080. *Lau* is disappointing in the failure of the Federal Court to consider the relationship between its decision in the case and its decision in *Australian Guarantee*. The latter decision is explained in the text of this volume as establishing a principle that an outlay which is the cost of an advantage that will be consumed over a period of years in a process of income derivation—in *Australian Guarantee* the advantage of the use of the borrowed money—will be deductible only as the advantage is consumed. It would follow from that principle that an outlay on management services to be performed by another over a period of years—21 years in *Lau*—is deductible, if deductible at all, over the period of years in which services will be performed. Alternatively the outlay may be seen as the cost of an advantage that is a structural asset and not deductible. The cost of the advantage of the long-term tie to which the garage
proprietor was made subject in *Strick v. Regent Oil Co. Ltd* [1966] A.C. 295 was held in that case to be a capital outlay.

Though the Federal Court in *Lau* did not consider the principle in *Australian Guarantee*, it did consider the possibility that the outlay was a capital outlay. Beaumont J. concluded that the outlay was a revenue outgoing because it was a payment for a regular return in services. The payment in *Strick v. Regent Oil*, unless a form approach centring on the payment as a payment of a premium is taken, was a payment for a regular return in the selling by the garage proprietor of the taxpayer's oil products.

The decision of the majority of the Federal Court in *Merv Brown* is disappointing. It gives no attention to the agency cases. The failure of the Supreme Court to give attention to the agency cases is noted in the text of the Volume at [2.486]. With respect, the question in *Merv Brown* was not whether the sale of the import entitlement was a normal incident of trading activities or a purpose for which the taxpayer carried on business. The question was simply whether the import entitlement was a revenue asset, and that was to be answered in terms of the significance of the import entitlement to the taxpayer's business operations. In none of the agency cases was the question posed by the Federal Court given any attention. Indeed it could not be said of any of the cases in which the agency was held to be a revenue asset that sale was ever contemplated. In all cases the realisation of the agency was by way of a surrender of the rights given by the agency for a sum of money. The decision of the Federal Court involves the consequence that the cost incurred by a taxpayer in the circumstances of *Merv Brown* in the purchase of an import licence is not at any time deductible by him, notwithstanding that the cost is incurred in carrying on his business. It must be seen as the cost of a structural asset, and no amortisation provisions are available.

The decision of Lusher J. in *Creer* (1985) 85 A.T.C. 4104, like the decision of the Federal Court in *Lau*, fails to consider the principle in *Australian Guarantee* which would have directed that the payments of rent in advance should be spread over the periods of the leases. And the decision allows an immediate deduction of the rent paid in advance without any consideration being given to the relevance of the outgoing to the derivation of income. That relevance, it is submitted, depended on the prospect that the property leased to the taxpayer would continue to be used by him in a process of income derivation, presumably by sub-letting. The onus of showing relevance rested on the taxpayer. The discussion of *Ilbery* (1981) 81 A.T.C. 4661 in the text of the Volume at [6.117-136] and [11.117-120] is in point.

The decision of David Hunt J. in *Gwynvill Properties Pty Ltd* (1985) 85 A.T.C. 4046 distinguished *Ilbery* on the ground, amongst others, that the taxpayer in that case did not carry on a business. David Hunt J. held that the taxpayer in *Gwynvill* was entitled to a deduction for interest paid in advance, and the interest was deductible on payment. The assumption that the second limb of s. 51(1) allows deductions on a more generous basis than the first limb is not supported by authority. *Gwynvill*, like *Creer*, fails to consider the principle in *Australian Guarantee*. Relevance to the derivation of income was assumed rather than expressly found. The payment was an amount of interest for a period of five years.
A demonstration of relevance where a payment of interest is made in advance may be easier where the taxpayer conducts a business and the amount borrowed has become part of the funds available for use in the conduct of the business.

The judgment of David Hunt J. includes an affirmation (at 4056) that “... contrary to the Ramsay principle applicable in England, it remains necessary to consider and respect the legal form of the transaction in question ... it is not legitimate to disregard ... the nature of the contracts made; and there is no room in this connection for taxation by end result or economic equivalence ...”. This affirmation, made in relation to deductibility under s. 51(1), is an expression of the extended form and blinkers approach considered in the text of the Volume, more especially at [6.83-84, 108–111] and [9.17-26]. There is no reference in the judgment in Gwynvill to the rejection of the extended form and blinkers approach by Dixon J. in Hallstroms Pty Ltd, referred to in the text of the Volume at [9.18], or to the support given Dixon J. by Gibbs J. in South Australian Battery Makers referred to at [9.19] in the text of the Volume.

Mutual Acceptance Limited (1984) 84 A.T.C. 4831 is an application of the principle that a gain arising on the discharge of a liability on revenue account is income. At the request of the lender a finance company repaid a borrowing by the payment of a lesser amount than the amount it had borrowed. The principle has been established in cases relating to exchange gains considered in the text of the Volume in [6.327-329] and [12.192-211]. Enderby J. undertook a lengthy review of the exchange gains cases in deciding that the borrowing by the finance company involved a liability on revenue account. His conclusion that “the gain had the character of income which could be expected to arise from time to time from the difference between the price of [the taxpayer's] borrowed money and the price of the money it loaned out” involves an assumption that the revenue character of the liabilities arising from the borrowings of a finance company is to be explained in the manner referred to in the text of the Volume at [12.210].

Kratzmann's Hardware Pty Ltd (1985) 85 A.T.C. 4138 is an application of the High Court's decision in Murphy's case (1961) 106 C.L.R. 146, considered in the text of the Volume at [12.102-106]. The principle is sometimes expressed as “once trading stock, always trading stock”. The decision also raises a question of the correlation between continuing business principles and the operation of s. 25A(1). One would have thought that a transaction of acquisition which was a transaction of a continuing business could not be seen as the first step of a s. 25A(1) transaction in the event that the business was discontinued. This would be at odds with the views on the correlation between continuing business principles and s. 25A(1) expressed in Investment and Merchant Finance (1971) 125 C.L.R. 249 and Whitfords Beach (1982) 150 C.L.R. 355. The matter of correlation is considered in the text of the Volume in [2.431-436] and [3.4-11].

In Milton Corporation Ltd (1985) 85 A.T.C. 4243 the Commissioner sought an extension of the so-called banking and life assurance cases to the circumstances of a company whose business was, in the view of the court, the borrowing and lending of money. Those cases are considered in the text of the Volume at [2.455-477]. The extension sought would parallel the extension of the life assurance cases
to the circumstances of a taxpayer carrying on a general insurance business in *Chamber of Manufacturers Insurance Ltd* (1984) 84 A.T.C. 4315 discussed in [2.476-477]. The decision of Lusher J. in *Milton Corporation* might be said to accept that the extension sought by the Commissioner is appropriate. His conclusion was, however, that the principle of the banking cases did not require on the facts of the case before him that profits on the sale of the investments should be treated as income. In reaching this conclusion he recognised and adopted, in relation to a business of borrowing and lending money, the formulation of principle in the Federal Court in *Chamber of Manufacturers* that gains on the sale of investments that are part of a “reserve fund” are income. His notion of a “reserve fund” is “standby funds to meet . . . a run” (at 4249), which is a more limited notion than that of a fund “to meet claims and expenses in all reasonably foreseeable contingencies” adopted by the Federal Court in *Chamber of Manufacturers* (at 4318-9) and considered in the text of the Volume at [2.475-477]. The investments in *Milton Corporation* were not held as part of the standby funds.


*Kelly* (1985) 85 A.T.C. 4283 is an application of a principle considered in the Volume in [2.162]. A prize may be income as a reward for services where it is connected with the rendering of services to a degree which will make it a product of those services. The connection that will make it a product does not require that the giving of the prize was, in the intention of the donor of the prize, to reward the taxpayer for services rendered by the taxpayer to his employer or to the donor. It is enough that competing for the prize is incidental to the taxpayer's employment. In *Kelly* the prize was for the “best and fairest” footballer, and the donor was a television station. The general principle stated in the Volume in Proposition 13 [2.367-428] that a gain that is a reward for services is income might be better expressed as “a gain which is a product of services is income”. The word “reward”, unless understood in a broad sense, may be too limiting. The word “product” will embrace a receipt which is incidental to the employment.

The decision of Murphy J. in the Victorian Supreme Court in *Myer Emporium Pty Ltd* (1985) 85 A.T.C. 4111 raises questions of some significance. The conclusion of Murphy J. was that the sale by Myer of the rights to future interest, separated from the right to repayment of the loan, was a sale of a structural asset, and that the proceeds were not in any part income. He rejected an argument that the proceeds were income as compensation receipts. The question whether the proceeds of realisation of a structural asset may be income as compensation for income flows that might have been derived from the asset is considered in the text of the Volume in [2.510-517]. The view that the rights to interest receipts constituted an asset independent of the debt for the money lent and could be disposed of by assignment, supports the view taken in [13.32-34] of the text of the
Volume. That view is that an assignment of rights to future receipts is an
assignment, in the metaphor adopted by Kitto J. in *Shepherd* (1965) 113 C.L.R.
385, of a tree from which the future receipts may be derived by the assignee as
income receipts. The period for which the taxpayer thought it necessary to make
the loan in *Myer* in order that the assignment might escape the operation of Div.
6A of Pt III, assumes a view of the operation of Div. 6A which is not accepted in
the text of the Volume. The matter is considered at [13.85-90]. Had the loan been
regarded as a revenue asset there would have been awkward questions in
determining the profit that was income on the sale of the rights to future interest.
Murphy J. was conscious of the problem. The provisions of legislation
foreshadowed in the Government's statement of 17 December 1984 in regard to
deferred interest securities and securities issued at a discount will include a
provision whereby an issuer who buys bonds and makes separate sales of the right
to the principal sum and of the rights to the receipts of interest, will have a cost of
the rights determined by an apportionment of what it has paid for the bonds. Those
provisions will not it seems apply to the sale of the rights by a taxpayer in the
situation of Myer who was not a purchaser of the loan and its attendant rights but
the original lender. As a matter of general principle it might be doubted, in any
event, that any outlay in acquiring or making a loan can be seen as a cost of future
interest. It will follow that the seller of the rights, if they are seen as part of a
revenue asset, will generate income in the amount of the gross proceeds. At the
same time the sale of the loan separated from the rights will have a cost of the
whole amount outlaid. The selling of the loan and the retention of the rights to
interest raises the possibility of generating a deductible loss. There may be thought
to be a need of a provision such as in s. 6BA to achieve generally what is proposed
in a limited context in the foreshadowed provisions in relation to the issue of
securities at a discount. Those foreshadowed provisions will presumably apply to
the finance company buyer in a *Myer* situation so that it will not be entitled to an
immediate deduction of the cost of acquiring the rights to future interest receipts.
As a matter of general principle the submission would be made that the cost is the
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Part I: Assessable Income
Chapter 1: Jurisdictional Aspects and The Meaning of Income

Levy and Imposition of Tax

1.1 By s. 17 of the *Income Tax Assessment Act*, income tax is levied “upon the taxable income derived during the year of income by any person”. In the case of a natural person, other than a natural person in the capacity of a trustee, tax is imposed on taxable income of a year of income, by the *Income Tax (Individuals) Act* applicable to that year of income, at rates declared by the *Income Tax (Rates) Act*. In the case of a company (other than a company in the capacity of a trustee) tax is imposed on taxable income of a year of income by the *Income Tax (Companies, Corporate Unit Trusts and Superannuation Funds) Act* applicable to that year of income. “Company” is defined in s. 6. It includes all bodies or associations, corporate or unincorporate, but does not include partnerships.

1.2 Where a person derives income in the capacity of a trustee, save where he derives in the capacity of a trustee of a superannuation fund, tax is levied by ss 98, 99 and 99A of Div. 6 of Pt III on the whole of, or a share of, “the net income of the trust estate” derived during the year of income. Section 17 would appear to be inapplicable, because the trustee does not derive “taxable income”, though net income of the trust estate is by s. 95 calculated in the manner applicable to the calculation of the taxable income of a natural person, or a company, that is not a trustee. The notion of year of income is in this instance imported by the hypothesis—“as if the trustee were a taxpayer”—on which the calculation is made. Tax is imposed by the *Income Tax (Individuals) Act* applicable to the year of income.

1.3 Where a person derives income in the capacity of trustee of a superannuation fund, tax is levied by ss 121CA, 121CB, 121D, 121DA and 121DAB of Div. 9B of Pt III on “income” (s. 121CA), “income” (s. 121CB), “investment income” (s. 121D), and “the amount” (ss 121DA and 121DAB) of a year of income. An amount on which tax is levied by these sections, other than s. 121D, is by s. 121DC deemed to be “taxable income”, and would for this reason be the subject in any case of levy by virtue of s. 17. Tax is imposed by the *Income Tax (Companies, Corporate Unit Trusts and Superannuation Funds) Act* applicable to the year of income.

1.4 “Year of income” is defined in s. 6. In relation to a company (except a company in the capacity of a trustee), it means the financial year next preceding the “year of tax”, or the accounting period, if any, adopted under
s. 18 of the Assessment Act in lieu of that financial year. By s. 6, “year of tax” means the financial year for which income tax is levied. In relation to a person other than a company, and in relation to a company in the capacity of a trustee, “year of income” means the financial year for which income tax is levied, or the accounting period, if any, adopted under s. 18 in lieu of that financial year. Thus companies, other than companies in the capacity of trustees, are taxed on a preceding year basis, and other persons are taxed on a current year basis.

1.5 Section 18 provides that, with the leave of the Commissioner, any person may adopt a substituted period, being the 12 months ending on some date other than 30 June. Leave to adopt a substituted accounting period is not readily given. If leave is given, it will be given on such terms as to ensure that tax is not avoided or deferred by the adoption of the substituted period.

1.6 Section 17 levies tax on “taxable income”. By s. 6, “taxable income” means “the amount remaining after deducting from assessable income all allowable deductions”. “Allowable deduction” means “a deduction allowable under [the] Act”. Where tax is levied on “net income of a trust estate”, under Div. 6 of Pt III, in the hands of a trustee, or on an amount, however named, in the hands of a trustee of a superannuation fund under Div. 9B of Pt III, the calculation requires the bringing in of “assessable income” and the deduction of “allowable deductions”.

1.7 “Allowable deductions” are the subject of Part II of this Volume. What is included in assessable income depends on the claims to jurisdiction to tax made in the Assessment Act. It also depends on the meaning of income, a matter explored in some depth in this Part. The operation of the claims to jurisdiction, and the boundaries of the concept of income, raise questions about the structure of the Assessment Act. Some indication of these questions is given by drawing attention to one further phrase in which the word “income” appears in the Act— the phrase “gross income” in s. 25. Omitting words added in 1984, that section, in subs. (1), provides:

“The assessable income of a taxpayer shall include—

(a) where the taxpayer is a resident—the gross income derived directly or indirectly from all sources whether in or out of Australia; and
(b) where the taxpayer is a non-resident—the gross income derived directly or indirectly from all sources in Australia,

which is not exempt income.”

1.8 A submission of this Volume is that any item which enters “assessable income”, in the sense of an amount from which allowable deductions are
deducted to bring out an amount of income on which tax is levied, must have entered through s. 25(1). The word “gross” in the phrase “gross income” is intended to ensure that the phrase embraces all items which are made income by the Assessment Act. Associated with this submission is another—that, at least for purposes of tax by assessment, the word “income” as used in the Assessment Act has only one meaning, a meaning drawn from all the provisions of the Act.

1.9 It will be seen that the existence of a coherent structure in the provisions of the Assessment Act depends on these submissions being valid. It is acknowledged that the first submission has been made untenable by words added to s. 25(1) in 1984. A redrafting can however restore a coherent structure without any abandonment of the intention of the added words.

The Relevance of Residence in Australia and of Source in Australia

1.10 The effect of s. 25(1), s. 23(q) and subss (1) and (1A) of s. 44 may be summarised as follows:

(i) A taxpayer who is a resident of Australia is liable to income tax on his income from all sources, subject to the exception that he is exempt from Australian tax on income (other than dividends) which has an ex-Australian source and is not exempt from income tax in the country of source, or is subject to royalty payment or export duty in that country.

(ii) A taxpayer who is not a resident of Australia is liable to income tax on income which has an Australian source. He is exempt from income tax on income which does not have an Australian source (s. 23(r)).

1.11 These propositions require qualification where the item of income is interest or royalties derived from sources in a country with which Australia has a double tax Agreement, and the relevant Agreement limits the rate of tax which may be imposed by the country of source. In these circumstances the interest or royalties is not exempt from Australian tax (Income Tax (International Agreements) Act, s. 12), but credit against Australian tax will be given under the terms of the relevant Agreement and the provisions of the Income Tax (International Agreements) Act.

1.12 Where a dividend paid from profits having a source out of Australia is received by a taxpayer who is a resident of Australia, and the dividend has been taxed in the country of residence of the company paying the dividend, there will, generally, be a credit under s. 45 of the Assessment Act against the Australian tax on the dividend. There will however be no credit if the
taxpayer receiving the dividend is a company and there is a full rebate of tax on the dividend under s. 46. There is, in effect, in this situation no Australian tax against which credit might be allowed: see subss (2) and (3) of s. 46 of the Assessment Act and subss (4) and (5) of s. 15 of the Income Tax (International Agreements) Act.

1.13 “Resident of Australia” is defined in s. 6. There are some specific provisions of the Assessment Act in regard to source, for example ss 25(2) and 44(1), but generally the meaning of source is left to judicial interpretation. Section 44(1) determines source in relation to a dividend. The subsection, it should be noted, is not an independent provision operating parallel with s. 25(1): its function is to explain s. 25(1) where the item in question is a dividend.

1.14 These propositions as to the relevance of residence and source will require qualification in some circumstances when there is a double tax Agreement between Australia and another country, and the provisions of the Agreement have been made law by enactment as a Schedule to the Income Tax (International Agreements) Act.

1.15 Where the levy of tax does not depend on a calculation of taxable income by the subtraction of allowable deductions from assessable income of the person subject to the levy, the application of the tests of jurisdiction in s. 25(1) presents difficulties. Until 1979, Div. 6 of Pt III required a calculation of “net income of the trust estate”, on which a beneficiary or the trustee might be subject to tax, by making an hypothesis that the trustee was a taxpayer who derived income. The hypothesis did not attribute any residence status to this notional taxpayer, and the High Court in Union-Fidelity Trustee Co. (1969) 119 C.L.R. 177 held that the only test of jurisdiction in s. 25(1) that could be applied was source of the income. It followed that the levy of tax on the trustee provided for in Div. 6 could apply only to Australian source income. Division 6 has now been amended so that the calculation of what is now referred to as “net income” is made on the hypothesis that the notional taxpayer is an Australian resident. Where the levy of tax is on the trustee, jurisdiction is now claimed on the basis that the trust estate is a resident trust estate, as defined in Div. 6.

1.16 The application of the tests of jurisdiction in s. 25(1) presents like difficulties in relation to the levy of tax on the trustee of a superannuation fund by Div. 9B of Pt III. In only one instance does the drafting of Div. 9B take into account the decision of the High Court in Union-Fidelity Trustee Co. (1969) 119 C.L.R. 177. Section 121D imposes a liability to tax on the trustee of a superannuation fund in respect of income that is “investment income”, defined in s. 121B. Investment income is the income of a s. 23F employees' superannuation fund, or a s. 23(ja) self-employed person's fund,
that is denied the exemption from tax that it would otherwise have under one of those provisions because of a failure of the fund to meet the requirements of investment in Government securities imposed by s. 121C. Tests of jurisdiction are imposed by the definition which requires calculation “as if the trustee of the fund were a taxpayer in respect of that income, being a resident”.

1.17 Section 121CA imposes tax on other income of a s. 23F fund which is denied exemption by provisions of s. 23F itself, but there are no jurisdictional tests specified, and it is arguable that the *Union-Fidelity* decision will apply so that the income on which tax is imposed will be limited to Australian source income. Indeed s. 121CA is deficient in another respect. By not referring to the condition “as if the trustee were a taxpayer” that appears in the definition of investment income, it opens the way to an argument that the fund does not have any income because the fund does not derive beneficially.

1.18 Section 121CB imposes tax on the trustee of a s. 23FB superannuation fund—an employee or self-employed person's fund meeting the conditions imposed by s. 23FB—in respect of “assessable income” of the superannuation fund. The reference to assessable income is presumably a reference to income that is not exempt income by virtue of s. 23FB. But no tests of jurisdiction are specified, and the *Union-Fidelity* decision may apply. Again there is no condition “as if the trustee were a taxpayer”.

1.19 Section 121DAB imposes tax on the trustee of a superannuation fund that is not of any of the kinds already referred to, and meets conditions imposed by the section. The drafting in this instance returns to the language “calculated as if the trustee were a taxpayer”. It does not however add the words “being a resident”, and thus does not take into account the *Union-Fidelity* decision.

1.20 Section 121DA imposes tax on the trustee of any other superannuation fund. The drafting follows the language of s. 121DAB, and thus does not take into account the *Union-Fidelity* decision.

1.21 Section 121DAA, which imposes tax on the trustee of an “ineligible approved deposit fund”, also follows the language of s. 121DAB. An ineligible approved deposit fund is presumably an “approved deposit fund” as defined in s. 27A(1), that is not an “eligible approved deposit fund” under s. 23FA.

1.22 A rational solution to the problems of jurisdiction posed by Div. 9B would be to treat the division as supplementing the law in Div. 6, which in turn simply explains the operation of s. 25(1). It would follow that Div. 6 would supply, in s. 95, the basis for determining the income of the superannuation fund, subject to any express exclusion, and a concept of a
resident trust. Section 25(1) would supply the tests of jurisdiction and thus
the basis of determination of assessable income. That determination would
have regard to the exemptions given by s. 23F and paras (jaa) and (ja) of s.
23 (as qualified by s. 121CB), and by s. 23FB.

1.23 Section 121DB, in providing that “Except as provided by Division
11A” (which relates to withholding tax) “the income of a superannuation
fund . . . is not subject to income tax otherwise than as provided by
[Division 9B]”, is not necessarily inconsistent with the solution offered.
Any alternative solution which would insist that Div. 9B owes nothing to s.
25 and Div. 6, will have unacceptable consequences. Thus the definition of
“investment income” in s. 121B, which includes the words “calculated as if
the trustee of the fund were a taxpayer in respect of that income, being a
resident”, when taken in conjunction with s. 121D which simply provides
that the trustee of the fund “shall be assessed and liable to pay tax . . . upon
the investment income of the fund” would involve an assertion of
jurisdiction to tax a foreign resident trustee on foreign source income. The
trustee is, in effect, deemed to be a resident and s. 23(r)—which exempts
income derived by a non-resident from sources wholly out of Australia—
could have no application. Where in other sections of Div. 9B the trustee is
simply deemed to be a taxpayer, Union-Fidelity Trustee Co. (1969) 119
C.L.R. 177 will preclude tax on an Australian resident trustee, save where
the income has an Australian source. Where no deeming at all is provided,
the superannuation fund will have no income. In the outcome Div. 9B
would be a rather sad bungle.

The Relevance of Residence in an Australian External
Territory and of Source in an Australian External Territory

1.24 The effect of s. 7A, added in 1973, is that the Assessment Act, subject
to Div. 1A of Pt III, operates in relation to the Territories of Norfolk Island,
Cocos (Keeling) Islands and Christmas Island as if they were part of
Australia.

1.25 Division 1A of Pt III provides for a number of exemptions which
mitigate the consequences of the extension of the Assessment Act, in this
way, to these Territories. The exemptions are in respect of income with
sources outside the Territories and Australia, and in respect of income with
sources in the Territories. The exemptions are available to individuals,
companies and trusts in various ways closely connected with one of the
Territories. And there is an exemption in respect of income from an office
or employment where duties are performed in one of the Territories by a
person who went to the Territory intending to remain for a period of more
than six months.

**Income Subject to Withholding Tax and Some Other Special Forms of Tax**

1.26 The discussion of s. 25(1) and, indeed, all the discussion so far in this chapter, has assumed that the income in question falls to be taxed by assessment.

1.27 The Assessment Act, in Div. 11A of Pt III, provides for the levy of income tax on income in the form of certain dividends and interest. This tax is referred to as withholding tax. It is levied, not by assessment, but by procedures of withholding under Div. 4 of Pt VI and, if necessary, by recovery of the tax, following service of a notice, from the person liable to pay the tax (s. 128C). The ascertainment of the amount of withholding tax is not an assessment (s. 128C(6)) and dividends and interest on which withholding tax is payable “shall not be included in the assessable income of a person” (s. 128D). The procedures of objection, reference and appeal are not available in relation to a levy of withholding tax. The levy may be challenged, where the tax has been collected by withholding, in proceedings to recover the tax under s. 221YS, or, where the Commissioner sues to recover the tax from the person he claims is liable, by way of defence in those proceedings.

1.28 A regime similar to withholding tax is applied by Div. 13A of Pt III, to film and videotape royalties paid to a non-resident. Liability for the tax is imposed on the receiver, but there are provisions for collection of the tax from the person making the payment. As in the case of withholding tax, the royalties are excluded from assessable income and thus from tax by assessment.

1.29 There are provisions in Div. 11C of Pt III relating to payments in respect of mining operations on Aboriginal land. Liability for tax on such payments rests on the person who receives the payment or for whose benefit the payment was applied. Tax may be collected from the person who makes a payment. It is expressly provided that ascertainment of the amount of tax is not an assessment. In other respects the relationship of tax under Div. 11C to tax by assessment is obscure.

**Meaning of Income in the Assessment Act**

**Structure**

1.30 The word income is used by economists and by lawyers. Economists tend to argue about what income “is”. The argument is obviously sterile,
though, as will be seen, it may be instructive to know what a particular economist means by the word. Lawyers argue about what the word means in a particular legal context. Trust law has a meaning for the word. Income tax law has another, perhaps two others, for purposes of tax by assessment and, it may be, yet another for purposes of tax by withholding. The income tax law meaning or meanings owe a good deal to trust law. But income tax law is fundamentally statute law, and the concern of this Volume is with the meaning of income as the word is used in the Assessment Act in relation to tax by assessment.

1.31 The submissions have been made in [1.8] above:

(1) that any item which enters “assessable income”, in the sense of an amount from which allowable deductions are deducted to bring out an amount of income on which tax is levied, must have entered through the word “income” in the phrase “gross income” in s. 25(1); and
(2) that the word “income” as used in the Assessment Act has only one meaning, a meaning to be drawn from all the provisions of the Act.

1.32 The first of these submissions may be identified as the central provision analysis of the structure of the Assessment Act. The second submission may be identified as the single meaning analysis. These submissions are at odds with conventional dogma which would assert, in contradiction of the second submission, that the word income as used in relation to tax by assessment has two meanings. One of these meanings is imported by the Act from the ordinary usage of the word. The other meaning refers to all items made income for purposes of the Act by provisions other than s. 25(1). Income in the first meaning is designated “ordinary usage income”. Income in the second meaning is generally, if not universally, designated “assessable income” with attendant confusion with the notion of assessable income as the amount from which allowable deductions are deducted to bring out an amount on which tax is levied. Conventional dogma, in this regard, may be identified as the two meanings analysis.

1.33 In contradiction of the first submission, conventional dogma would assert that the items which enter assessable income through s. 25(1) are only those items which are income in the ordinary usage of the word. Other items enter by virtue of other provisions by which items are specifically described and are designated “assessable income”. Conventional dogma, in this regard, may be identified as the parallel provisions analysis. It is an analysis which has received legislative endorsement by words added to s. 25(1) in 1984.

1.34 If items, which one might be allowed to describe as items “made
income” by provisions other than s. 25(1), are carried direct to assessable income by those provisions, the Assessment Act would appear to assert an unlimited jurisdiction to tax them. And it would appear that none of these can ever be excluded from tax as exempt. Save s. 44(1), and then only in relation to jurisdictional limitations, none of these other provisions contains any jurisdictional limitations or any exclusion as exempt. Thus s. 26 opens with the words “the assessable income of a taxpayer shall include”, and then lists items in a series of paragraphs.

1.35 It may be argued that s. 23(r) supplies the jurisdictional limitations. But that provision applies, on the parallel provisions analysis, only to items which are income within the ordinary usage of the word. And, in any case, s. 23(r) operates through s. 25(1) to prevent an item becoming assessable income. It cannot take out of assessable income an item which has already been carried to assessable income. These observations in regard to s. 23(r) may also be made in relation to other provisions which purport to exempt items for reasons other than jurisdictional limitations. Among these are the other paragraphs of s. 23.

1.36 The central provision analysis avoids the fatal flaws. Parke Davis & Co. (1959) 101 C.L.R. 521, which is the principal source of support in judicial opinion for the central provision analysis, was concerned with s. 44 (1) which in fact carries its own jurisdictional limitations, though not the exclusion from tax by exemption. The latter would be supplied by the central provision analysis. Income which is made such by s. 44 is taken up into the word “income” in s. 25(1). If it is within any category of exemption, it will, by the exclusion of exempt income expressed in s. 25 (1), be prevented from entering assessable income.

1.37 Though it avoids the fatal flaws, the central provision analysis must admit to some problems which arise from the drafting of s. 25(1) and of the specific provisions. And it must admit to the rejection of the analysis by words added to s. 25(1) in 1984. The word “gross” is used in conjunction with the word “income” in s. 25(1). There is a line of reasoning which would begin with the assertion that income within the ordinary usage of the word is always a gross amount, in the sense of an amount which is “not net”. Out of this assertion, indeed, has come the conventional dogma that the Assessment Act, save where there is some express provision, brings into assessable income a receipt and never a profit. The argument would go on to a conclusion that s. 25(1) must be concerned only with income within the ordinary usage of the word since some, at least, of the items with which other provisions are concerned are profits and not gross amounts. The assertion that income in the ordinary usage of the word is always a gross amount, is challenged in this Volume. In any case, the use of the word
“gross” does not connote “not net” of any cost. If it did, the accounting notion of “gross profit” would involve a contradiction in terms.

1.38 There is another reply to any argument based on the word “gross” that is directed against the central provision analysis. Where the word is used in an arithmetical sense, it has another meaning—“total”. In this meaning the word asserts the central provision analysis. The reference to “gross income” in s. 25(1) is to all items which are income for the purposes of the Assessment Act.

1.39 An amendment to s. 25(1) in 1984 added the following words at the end of the subsection: “an amount to which s. 26AC or s. 26AD applies or an eligible termination payment within the meaning of Subdivision AA.” It must be acknowledged that the amendment proceeds on the parallel provisions analysis. The amendment involves an assumption that without it “an eligible termination payment”, for example, might be included in assessable income both under s. 25(1) and Subdiv AA of Div. 2 of Pt III. The assumption adopts the minority view of Stephen J. in Reseck (1975) 133 C.L.R. 45, where the question was whether s. 25(1) could include in assessable income the whole of an amount that s. 26(d) expressly provided should be included only as to part of its amount. Stephen J. held that it could. The assumption has a tangle of implications in relation to other sections of the Act that make express provision which on the central provision and single meaning analyses will simply go to the meaning of income for purposes of s. 25(1), and it is inconsistent with the assumption behind the drafting of other provisions. Thus, s. 26AAC(10), in excluding the operation of s. 26(e) in relation to benefits in the form of the issue of shares or share options to employees, proceeds on the assumption that the meaning of income in s. 25(1) is thus modified. No express provision has been made in s. 25(1) in regard to s. 26AAC, in the manner of the words now added to s. 25(1) in relation to “an eligible termination payment”. Comment on s. 25AAC(10) is made in [2.25] below. It is fair to say that parity with the reasoning behind the words now added to s. 25(1) would require express provision in s. 25(1) excluding from s. 25(1) any specific provision that is intended to cover the relevant field. Thus the provisions of s. 44(1) and following sections, even though intended to cover some or the whole of the field of corporate distributions in determining their income character, will fail in that intention unless there are further words added to s. 25(1) excluding the operation of s. 25(1) in relation to such distributions.

1.40 The aspect of the general pattern of drafting which is most awkward for the central provision analysis is the use of the same words in the opening of s. 25(1) as in the specific provisions. These opening words are “The assessable income of a taxpayer shall include”. The central provision
analysis would be unquestionably valid if the word “means” were used in s. 25(1) instead of “includes”, and if the specific provisions referred only to “income” and not to “assessable income”. The parallel opening words of s. 25(1) and of the other provisions may be thought to suggest the parallel provisions analysis. But they are ambivalent: they equally suggest that the provisions subsequent to s. 25(1) fulfil or carry out s. 25(1).

1.41 The single meaning analysis advanced in the second submission of this Volume concedes that in the fashioning of the word “income” in s. 25(1) one must begin with the meaning of the word in ordinary usage. To this extent the meaning of the word income for purposes of the Assessment Act draws on the ordinary usage meaning of the word. Some specific provisions may simply declare that some part of the meaning of the word income in ordinary usage is income for purposes of the Assessment Act. Other specific provisions, in fashioning the meaning of “income” in s. 25(1), may extend, limit or modify the meaning of the word in ordinary usage. Whether a specific provision operates to limit, or modify by limiting, is a matter of construction of that provision. Unless the specific provision expressly provides that an item which is in fact within the ordinary usage of the word income, shall not be included in assessable income, the construction of the provision requires a decision as to whether the specific provision “covers the field” in which the item lies, or may be said to be a code in relation to a group of items of which it is one. Thus, it will be seen in [2.261] below, an answer to the question whether a cash distribution (other than the distribution referred to in s. 6(4)) by a company to its shareholder from share premium account is income, requires a decision whether Subdiv. D of Div. 2 of Pt III (which deals with dividends) is a code, and a code in relation to distributions by companies to shareholders. Where the specific provision expressly provides that an item shall not be included in assessable income, the single meaning analysis would assert that the meaning of income for purposes of the Act does not include that item.

1.42 The two meanings analysis raises acute problems as to what is to be taken to be the meaning of income when the word is used in provisions which do not themselves define income, but rely on a meaning determined by other provisions of the Assessment Act. Among them are the definition of “exempt income” in s. 6(1), the word “income” in s. 47(1) and the word “income” included by the opening words of s. 23 in the various paragraphs of that section.

1.43 Judicial experience with the two meanings analysis is hardly encouraging. The problems of identifying the meaning intended by the word income as it is used in the definition of “exempt income” in s. 6(1),
or as it is used in s. 23 are resolved under the two meanings analysis, by choosing one of the meanings, but the resolution produces absurd results. The two meanings analysis dictates a choice between a conclusion that the word income as used in ss 6, 47 and 23 refers only to items which are such in the ordinary usage of the word or, it seems, are deemed to be income in the ordinary usage of the word, and a conclusion that the word refers only to items that are made income by specific provisions. It is an absurd view of the operation of the Assessment Act that s. 23(q) may exempt a trading profit from a foreign source but not a profit from a foreign source which is income only by force of s. 25A(1). It is equally absurd that s. 23(q) may exempt only income from a foreign source that is income by force of specific provisions. The perplexities of the attempt in Harrowell (1967) 116 C.L.R. 607 to reconcile the two meanings analysis with a meaning for the word income, in the phrase “represents income” in s. 47, which would include a deemed dividend arising in liquidation, condemn both the parallel provisions analysis and the two meanings analysis.

1.44 Whatever analyses are adopted, there is need to explore the ordinary usage meaning of income. It is the substratum of the meaning of income for purposes of the Assessment Act. In one provision, s. 26(f), it is expressly referred to in defining the scope of a specific provision. It might be expected that the content of ordinary usage income will be provided by judicial decisions, many of them United Kingdom decisions on the meaning of income in the United Kingdom income tax legislation. Chapter 2 of this Volume will examine the ordinary usage meaning, noting at the same time the provisions of the Assessment Act which confirm aspects of that meaning, or which, on a single meaning analysis, have the effect of excluding, limiting or modifying the ordinary usage meaning as it is imported into the meaning of income for purposes of the Assessment Act.

**Background: an economist's view of income**

1.45 As background to the examination of the ordinary usage meaning, and of the exclusions, limitations and modifications of that meaning, it is instructive to consider what is meant by income in the thinking of those economists who identify income with “accretions to economic power”. These economists would say that an income tax has a rational and appropriate operation so far as it taxes such accretions, and taxes only such accretions.

1.46 The view that accretions to economic power, also referred to as spending power, is the appropriate base for an income tax is most often associated with the name of Henry Simons. In his classic work, *Personal
Income Taxation (Univ. of Chicago Press, Chicago, 1938 [1980 Reprint]), he wrote (pp. 50–51):

“Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to ‘wealth’ at the end of the period and then subtracting ‘wealth’ at the beginning. The sine qua non of income is gain, as our courts have recognised in their more lucid moments—and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

This position, if tenable, must suggest the folly of describing income as a flow and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc. As Schäffle has said so pointedly, ‘Das Einkommen hat nur buchhalterische Existenz’. It is indeed merely an arithmetic answer and exists only as the end result of appropriate calculations. To conceive of income in terms of things is to invite all the confusion of the elementary student in accounting who insists upon identifying ‘surplus’ and ‘cash’. If one views society as a kind of giant partnership, one may conceive of a person's income as the sum of his withdrawals (consumption) and the change in the value of his equity or interest in the enterprise. The essential connotation of income, to repeat, is gain—gain to someone during a specified period and measured according to objective market standards.”

1.47 It is a view adopted in the Memorandum of Dissent contained in the Final Report of the United Kingdom Royal Commission on the Taxation of Profits and Income (1955, Cmd. 9474). That Memorandum may be taken to express the thinking of the English economist, Lord Kaldor, who was one of the three signatories of the Memorandum. It states (pp. 355–356):

“5. In our view the taxable capacity of an individual consists in his power to satisfy his own material needs, i.e., to attain a particular living standard. We know of no alternative definition that is capable of satisfying society's prevailing sense of fairness and equity. Thus the ruling test to be applied in deciding whether any particular receipt should or should not be reckoned as taxable income is whether it contributes or not, or how far it contributes, to an individual's ‘spending power’ during a period. When set beside this standard, most of the principles that have been applied, at one time or another, to determine whether particular types of receipt constitute income (whether the receipts are regularly recurrent or casual, or whether they proceed from a separate and identifiable source, or whether they are payments for services rendered, or whether they constitute profit ‘on sound accountancy principles’, or whether, in the words of the Majority . . . they fall ‘within the limited class of receipts that are identified as income by their own nature’) appear to us to be irrelevant. In fact no concept of income can be really equitable that stops short of the comprehensive definition which embraces all receipts which increase an individual's
command over the use of society's scarce resources—in other words, his ‘net accretion of economic power between two points of time’.

6. Definitions of income giving expression to this basic principle have been offered by various writers on public finance, all of which, subject to minor differences, agree in regarding ‘income’ as the sum of two separate elements, namely personal consumption and net capital accumulation. In the words of one writer income can be looked upon either as ‘(a) the amount by which the value of a person's store of property rights would have increased, as between the beginning and the end of the period, if he had consumed (destroyed) nothing; or (b) the value of rights which he might have exercised in consumption without altering the value of his store of rights’. Hence income is the ‘algebraic sum of (1) the market value of rights exercised in consumption, and (2) the change in the value of the store of property rights between the beginning and the end of the period in question’ (H. Simons, Personal Income Taxation, pp. 49–50).

7. The above definition focuses attention on two fundamental aspects of the concept of income which reflects the increment of ‘spending power’ or ‘economic power’ in a period. One is that income is a measure of the increase in the individual's command over resources in a period, irrespective of how much or how little of that command he actually exercises in consumption. The private choice of an individual as to how much he spends and how much he saves is irrelevant to this notion: income is the sum of consumption and net saving. The second is that ‘net saving’ (and hence income) includes the whole of the change in the value of man's store of property rights between two points of time, irrespective of whether the change has been brought about by the current addition to property which is saving in the narrower sense, or whether it has been caused by accretions to the value of property. From the point of view of an individual's command over resources, it is the change in the real value of his property which alone matters, and not the process by which that change was brought about.”

1.48 The view was also adopted in the Canadian Report of the Royal Commission on Taxation (1966), Vol. 1, pp. 9–10:

“We are completely persuaded that taxes should be allocated according to the changes in the economic power of individuals and families. If a man obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, received it because he held property, made it by selling property or was given it by a relative. Nor do we believe it matters whether the increased command over goods and services was in cash or in kind. Nor do we believe it matters whether the increase in economic power was expected or unexpected, whether it was a unique or recurrent event, whether the man suffered to get the increase in economic power or it fell in his lap without effort.

All of these considerations should be ignored either because they are impossible to determine objectively in practice or because they are irrelevant in principle, or both. By adopting a base that measures changes in the power, whether exercised or not, to consume goods and services we obtain certainty, consistency and equity.”
1.49 A tax on accretions to spending power will not be concerned to know whether that spending power has been exercised in consumption. There is thus a vital difference between an income tax, of the kind favoured by Simons, and a tax, such as a sales tax, which in its effective incidence may be seen as a tax on the exercise of spending power (whether power arising from current accretions, or from savings of past accretions). And there is a difference between a Simons income tax and a tax on spending power at a point of time such as an estate duty or an annual wealth tax.  

1.50 The Memorandum of Dissent ([1.47] above) supports an income tax on accretions to spending power over a period as a better income tax than the United Kingdom income tax as it operated at the time of the Royal Commission. One may take it, however, that Kaldor would prefer a tax on the actual exercise of spending power in consumption in the form, not of a sales tax, but of an expenditure tax—a phrase used here to refer to a tax with a progressive rate structure and a base which is the total of an individual's exercises of spending power over a period. Kaldor's preference for an expenditure tax is expressed in his book *An Expenditure Tax* (George Allen & Unwin, London, 1955). The Canadian Royal Commission did not share Kaldor's preference. The Canadian Commission was a most powerful advocate for an income tax with a base of accretions to spending power.  


Some comparisons with the Assessment Act's view of income  

1.52 It will be apparent from the examination of the meaning of income in the Assessment Act undertaken in Pt I of this Volume that the base of our income tax differs in a number of respects from the base advocated by Simons, Kaldor and the Canadian Royal Commission, a base which may be identified as the “comprehensive tax base”. While generally the base of our income tax is made up of accretions to spending power, the base may
include an item because of an element of periodicity in its derivation, even though that item reflects only a realisation of an asset: there has been no more than a transformation of spending power. It will be seen in [2.215]ff. and [4.106]ff. below, that s. 27H of the Assessment Act seeks to prevent tax on the transformation-of-asset element in periodical receipts, so as to leave only the accretion element subject to tax, but it does not achieve this result in all circumstances.

1.53 There is a view of the operation of the Assessment Act which would say that, unless there is some express provision to the contrary, the Act taxes “receipts” in some primitive sense that connotes “what comes in”, and does not embrace a gain which must be calculated by the subtraction of an expense from a receipt. This view is rejected in this Volume. So far as it is a correct view, that view involves the consequence that the base of the income tax will include the proceeds of realisation of an asset as distinct from the profit from that realisation. In this there would be a stark difference from the comprehensive tax base. And it would be no justification of that difference to say that the cost of the asset has most likely been allowed as a deduction in fixing the base of the tax in an earlier year. That deduction would itself have been at odds with the comprehensive base, since it would have diminished the base in circumstances that did not reflect any decrease of spending power.

1.54 The more obvious differences between the base of our income tax and the base advocated by Simons concern want of comprehensiveness of the former. There are however two preliminary points that should be made. In one respect both our income tax and the comprehensive base are less than comprehensive. None of Simons, Kaldor and the Canadian Royal Commission would, as a general rule, include in an income tax base the unrealised appreciation in the value of an asset. Simons' broad pronouncements quoted above may suggest that he advocated the inclusion of unrealised appreciation. But in other parts of his text he was at least equivocal on the matter, and probably favoured realisation of the accretion as a condition of the inclusion of an item in the base. The Memorandum of Dissent signed by Kaldor includes the following:

“8. In applying the basic conception of income as the power to satisfy material needs to any workable tax system, a number of guiding principles need to be introduced. (1) The first of these is, in the words of the Majority... that ‘no income [should be] recognised as arising unless an actual receipt has taken place, although a receipt may take the form of a benefit having money's worth received in kind as well as of money or of a payment made to a third party in discharge of another's legal debt’. The obvious corollary to this principle is that no deduction should be recognised from any gross receipt in arriving at the net receipt unless an actual
outlay has taken place, whether in money or money's worth. Hence improvement or
deterioration in the market value of a man's property should not be recognised until
it is reflected (as in the long run it must be) in his actual receipts, or in the outlays
that he can properly charge against those receipts . . . ” (United Kingdom Royal

The Canadian Royal Commission favoured realisation as a condition of the derivation
of an accretion, though with some qualification. Thus the Commission favoured a
principle that gains in the value of property should be deemed to have been realised
on the death of the owner.

1.55 The scope for including unrealised appreciations in the base of our
income tax is limited, it will be seen, by the general exclusion of capital
gains from the base. Where there is scope, there is no required inclusion of
unrealised gains, though there may be an inclusion under the trading stock
provisions, considered in Chapter 14, at the choice of the taxpayer who
wishes to anticipate a profit.

1.56 In another respect both our income tax and the comprehensive tax
base may be thought to be more than comprehensive. They may include
accretions which are unreal. Simons was aware of the distortion of the base
that could arise in times of inflation. He said (in Personal Income
Taxation, p. 55):

“Our definition of income may also be criticised on the ground that it ignores the
patent instability of the monetary numéraire . . . and it may also be maintained that
there is no rigorous, objective method either of measuring or of allowing for this
instability. No serious difficulty is involved here for the measurement of
consumption—which presumably must be measured in terms of prices at the time
goods and services are actually acquired or consumed. In periods of changing price
levels, comparisons of incomes would be partially vitiated as between persons who
distributed consumption outlays differently over the year. Such difficulties are
negligible, however, as against those involved in the measurement of accumulation.
This element of annual income would be grossly misrepresented if the price level
changed markedly during the year. These limitations of the income concept are real
and inescapable . . . ”

But he offered no solution.

1.57 The Memorandum of Dissent signed by Kaldor observes:

“38. It must also be remembered that taxable capacity is essentially a relative
concept, and those property owners who make capital gains during an inflation are
undoubtedly in a better position than those who own fixed interest securities, and
who therefore lose part of their real capital as a result of the rise in prices. Equity
cannot be secured by ignoring relative changes in the taxable capacities of different
property owners; and, if it were held to be desirable (and possible) to exempt that
part of capital appreciation which was commensurate with the general price rise, it
would follow that any lesser degree of capital appreciation should be regarded as a
loss. It is not our view that the tax code should be so devised as to insure taxpayers against the risk of inflation. Indeed we should consider any such intention singularly inappropriate, for taxation must be regarded as one of the principal weapons in the armoury of the central government for combating inflation. In the event of a drastic depreciation it might become necessary to revise the basis of all monetary obligations and commitments, including tax payments—as was done in Belgium after the First World War, and in Belgium and France after the Second World War. But we do not regard such a situation as within the foreseeable circumstances which tax regulations, or tax reforms, should take into account.” (United Kingdom Royal Commission on Taxation of Profits and Income, Final Report (1955, Cmd. 9474), p. 366).


“It has been argued that it would be inequitable to tax a gain that resulted from a general increase in the price level. The point is made that such a gain is illusory because it does not represent any real increase in purchasing power. This argument, when used to support the exemption of stock market gains, appears over-emphasised if the substantial increases in the stock market averages are compared with the rather smaller increase in the cost-of-living index. In addition, we cannot overlook the fact that there are many members of society with fixed incomes who suffer losses in economic power because of inflation and are unable to protect themselves against it. This is in contrast to the equity holder who, during a period of inflation, will generally experience some growth in the dollar value of his assets. Because it is not possible to make provision for complete recognition of declines in purchasing power brought about by inflation, we have concluded that it should not be the function of the tax system to attempt to relieve only some segments of the population from the effects of inflation. The tax system should therefore, in our opinion, continue to be based on current dollars and not on constant dollars.”

1.59 Following recommendations made by the Mathews Committee (Report of the Committee of Inquiry into Inflation and Taxation (A.G.P.S., Canberra, 1975)) provisions were introduced into the Assessment Act to make an adjustment to the amount of gains from the sale of trading stock to allow for the effect of inflation. The adjustment was discontinued with effect from the end of the 1979 year of income. The relevant provisions are referred to in Chapter 15.

1.60 The point has been made that the differences between the base of our income tax and the base advocated by Simons concern a want of comprehensiveness of the former. Putting the differences in this way assumes that, to a degree, our income tax base does reflect an idea of accretions to spending power. The law in regard to periodical receipts and the view that the law taxes receipts, as distinct from gains, may raise doubts about that assumption. Nonetheless, the submission of this Volume,
and the manner in which the propositions expressing the ordinary usage notion are stated, assert that the law does reflect an idea of accretions. If an idea of accretions is rejected as irrelevant, we are left with no unifying idea, and the law appears as the accidents of usage and the pronouncements of judges. Such consequences were described in the Memorandum of Dissent from the *Final Report* of the United Kingdom Royal Commission in this way (p. 355):

“3. A system of personal income taxation which operates without any clear definition of what constitutes ‘income’ is exposed to a double danger. On the one hand the simple view that income is an unambiguous word, not subject to various interpretations, may ensure general complacency, and the particular notion of “taxable income” hallowed by legal tradition tends to become identified with taxable capacity as such. On the other hand, in the absence of any clear underlying principle, revisions and interpretations of the law proceed, in the light of particular considerations, to introduce successive concessions which have the effect of constantly shifting the tax burden in a manner which is no less far-reaching for being unobtrusive. Lacking a firm basic conception, neither the public nor the legislature nor the courts are conscious of the extent to which the tax system, behind a facade of formal equality, metes out unequal treatment to the different classes of the taxpaying community.”

1.61 The want of comprehensiveness of the base of our income tax is evident in the failure, complete or partial, to include in the base the following accretions to spending power:

(1) capital gains: gains from the realisation of property, when the realisation is not an aspect of the carrying on of a business, or the carrying out of an isolated business venture;
(2) bequests and gifts received;
(3) lottery and casual gambling winnings;
(4) retirement benefits and compensation for loss of office or employment, received in a lump sum;
(5) compensation for injury to person or reputation received in a lump sum; and
(6) non-money accretions to spending power.

**Capital gains**

1.62 Except to a limited extent resulting from the provisions of s. 25A(1) and s. 26AAA of the Assessment Act, considered in Chapter 3, which define the base so as to include gains from the sale of property acquired for the purpose of profit-making by sale and gains from the purchase and sale of property made within a period of 12 months, capital gains are not included in the base of our income tax. Whether or not the base of the tax should be extended to include capital gains has been the subject of a good
deal of debate. The case for including capital gains is made in terms of the need to make the income tax comprehensive in order to cure inequity. There is a failure to treat equally persons with equal gains, and those who are not taxed because their gains are capital gains tend to be those who in total have the greater gains. Implicit is an assertion that the idea underlying the concept of income in our Act is accretions to spending power. The case for extending the base of the United Kingdom income tax to include capital gains was made in the same way by the Memorandum of Dissent contained in the Final Report of the United Kingdom Royal Commission on the Taxation of Profits and Income. The case for extending the base of the Canadian income tax was made by the Canadian Royal Commission in the same way.

1.63 The case against including capital gains is sometimes made in terms that the underlying idea of income in the Assessment Act does not embrace such gains. This argument tends to bury the debate in legal semantics which amount to no more than an assertion that the underlying idea cannot be accretions to spending power because capital gains are accretions and they are not included in income by the present law. The debate can only be instructive if the case against extension is put in terms of reasons why the equity argument for including capital gains should not prevail. A case can be made against extension in terms of not discouraging investment. That case was recognised by the Memorandum of Dissent from the United Kingdom Royal Commission's Final Report, and by the Canadian Report of the Royal Commission on Taxation. It finds expression in the special treatment accorded capital gains in both the United Kingdom law and the Canadian law. Since 1965, the United Kingdom has taxed capital gains under provisions distinct from those applicable to the income tax so that they are accorded privileged treatment. Canada, since its Royal Commission Report, has extended the base of its income tax so as to include in the base one half of capital gains.

1.64 The Australian Taxation Review Committee (the Asprey Committee), in its Preliminary Report in 1974, recommended the taxing of capital gains, but in a way that would preserve a privileged treatment for capital gains: they would be taxed at only one half of the rate applicable to income gains. Mr Crean, the Treasurer at the time, announced in September 1974, that capital gains not subject to the income tax would be taxed as from the date of the announcement in a manner in general accord with the recommendation of the Asprey Committee. Dr Cairns, who became Treasurer in the meantime, withdrew the announcement in January 1975.

1.65 It will be apparent from the discussion in the Taxation Review Committee's Full Report (A.G.P.S., Canberra, 1975) (see also Chapter 15
below) that there are problems associated with the taxing of capital gains which go beyond any discouragement of investment that the prospect of the tax may involve. The liquidity difficulties and the administrative and compliance difficulties in regard to valuation, which would attend a tax on unrealised gains, virtually dictate that the tax must be applied only to realised gains. A White Paper by the Canadian Government in 1969 (Proposals for Tax Reform, Ministry of Finance) did propose that Canada should apply a tax on unrealised gains in the value of Stock Exchange listed securities. The proposal was not implemented. But an optional system that will tax unrealised gains has now been introduced. A tax confined to realised gains discourages realisation. It has a “lock-in” effect, putting a brake on the mobility of capital. There is an attendant question as to what is to be done on the death of a taxpayer who holds assets which have increased in value. Canadian law deems a realisation at market value to have occurred on the death of the owner of assets, or on his making a gift of them. The United Kingdom law provided in this way initially. However it is now provided, in the case of death, that there is no realisation of a gain, though the person who acquires the asset takes it with a cost equal to its market value. Thus, death in the United Kingdom provides an “escape-hatch” from capital gains tax. The Asprey Committee proposed that there should be a deemed realisation on death, but also proposed that there should be a limited exemption from tax for gains realised on death, or realised after the age of 65. The United Kingdom law increases the “lock-in” effect of capital gains tax: there is a clear advantage in holding until death. The exemption proposed by the Asprey Committee would have a like effect until the taxpayer attains 65. The Canadian law and the general proposal of the Asprey Committee mitigate the lock-in effect by denying a death escape hatch.

1.66 A tax on realised gains creates “bunching” difficulties. A gain which may have accrued over a number of years will all be taxed in one year, unless some special provision is made. The Asprey Committee proposed that a special averaging device should be applied in taxing capital gains (Full Report, para. 23.36).

1.67 In conditions of inflation at least some element of a capital gain is likely to be unreal if the gain is calculated by subtracting the historical cost from the proceeds of realisation. The historical cost of an asset will be less than the cost expressed in terms of the value of money at the time of realisation. Simons, Kaldor and the Canadian Royal Commission were all aware of the difficulty, though none offered an answer. The Asprey Committee had no adequate answer. Indexation of the historical cost and the subtraction of the cost as indexed is appropriate where the taxpayer has
not used borrowed funds. Where he has borrowed, there should, on the face of it, be an adjustment to take account of the fall in value of the liability to repay the borrowing. But there will be difficulties in linking the acquisition of the asset and the borrowing. Inflation poses similar difficulties in relation to gains presently subject to income tax. Attempts to solve them in that context have not been successful. The matter is further considered in Chapter 15 below.

**Bequests and gifts received**

1.68 Simons proposed the inclusion of bequests and gifts received in the base of an income tax. The Canadian Royal Commission recommended their inclusion in the base of the Canadian income tax. However, no country has taken the idea of a comprehensive income tax base as far as Simons and the Canadian Royal Commission thought appropriate. Bequests and gifts have, generally, been left to the operation of death and gift taxes and accession taxes. The Canadian White Paper that followed the Report of the Royal Commission on Taxation asserted that bequests and gifts were the province of the Canadian estate and gift duties, and were not the province of the income tax. Canada's estate duty has since been repealed but bequests and gifts have not been included in the income tax base. Canada, it seems, now consider that it is enough that the capital gain in respect of the asset bequeathed or given is brought within the income tax as a result of the realisation deemed to occur at death or gift.

1.69 Bequests and gifts were until recently the province in Australia of the federal estate and gift duties, and of death and gift duties in the Australian States. The federal estate and gift duties have been abolished and State death and gift duties have almost all been repealed. These repeals raise questions about the Australian tax system as a whole. The Asprey Committee had agreed with the view that bequests and gifts are not the province of the income tax, but proposed the continued taxation of property the subject of bequests and gifts by strengthened and integrated death and gift taxes (Full Report, Ch. 24). The Committee had proposed a shift away from the present emphasis on income tax in the Australian tax system towards a broad-based tax on goods and services. Taxes on goods and services are taxes on consumption and leave saving untaxed. A shift away from income tax thus increases the scope for accumulation of wealth. Effective death and gift taxes will limit the transmission of that wealth by bequest or gift. The Asprey Committee's views may be said to favour the institution of inheritance against the view of the Canadian Royal Commission. The Commission, it will be recalled, expressed itself as
“completely persuaded” about the comprehensive tax base. But the Asprey Committee would nonetheless want such qualification on the institution of inheritance as may result from the operation of death and gift taxes. The comprehensive income tax base, when extended to bequests and gifts, denies any special treatment to accretions to spending power arising from inheritance or gift. Treating bequests and gifts as outside the province of the income tax opens the way to according them favoured treatment under death and gift taxes.

1.70 The exclusion of gifts from the base of the Australian income tax requires the drawing of a line which may not always be easily drawn. These difficulties are considered in [2.132]ff. below. It is enough for present purposes to note that some gifts in the sense of voluntary payments—for example the tip received by a taxi driver—are income of the taxpayer who receives them.

**Lottery and casual gambling winnings**

1.71 Such gains are referred to in this Volume as “windfall gains”. The phrase does not have a precise meaning. Indeed it is sometimes used to cover capital gains, and perhaps also bequests and gifts received. All these have some quality of unexpectedness, but this is hardly a justification for giving them a common classification and excluding them from the income tax base. In the case of lottery and casual gambling winnings, the justification for exclusion must rest on difficulties of administration and compliance.

1.72 Simons and the Canadian Royal Commission would have included them in the income tax base. The Memorandum of Dissent contained in the *Final Report* of the United Kingdom Royal Commission on the Taxation of Profits and Income is not uncompromising:

“...[R]eceipts which cannot reasonably be brought within the scope of taxation because their control and enforcement is beyond the power of any efficient tax administration are better ignored altogether (even though they are beneficial receipts) since their inclusion creates unfairness to the disadvantage of the honest taxpayer. (Gambling winnings may be regarded as an example of this.)” (Para. 8(2), pp. 356–357.)

1.73 The Australian income tax probably excludes lottery winnings from the base in all circumstances. It will in some circumstances treat gambling winnings as within the base—where there is a business of gambling or where gambling is incidental to some other business, for example, operating a casino or training horses. But where there is no business activity, gambling winnings are not within the base. To include all lottery
and gambling winnings would invite evasion. And honest taxpayers might find it difficult to prove their losing investments. If losing investments were denied as being consumption expenditure, the tax would be felt to be unfair. The Asprey Committee (Full Report, para. 7.8) did not propose that the tax base be extended to include lottery or casual gambling winnings.

**Retirement benefits and compensation for loss of office or employment, received in a lump sum**

1.74 The comprehensive tax base would clearly extend to the whole of each of these items. But the Australian income tax base extends to them in only a limited degree. Prior to 1 July 1983, only 5 per cent of the amount of an item of these kinds was included in the base, under s. 26(d). Since 1 July 1983, a payment in consequence of the termination of any employment of a taxpayer, or a payment made from a superannuation fund in respect of the taxpayer, is income under s. 27B where it relates to service after 1 July 1983, though it is taxed at lower rates than other income. If it relates to service before 1 July 1983, 5 per cent of the amount is included in income. The reason for this favoured treatment of a retirement benefit which is a reward for services may have been to give what appears to be a very generous relief against bunching. Where the benefit is not a reward for services, but comes, for example, from a superannuation fund, it would not, apart from s. 26(d), and now, s. 27B, be income. The ordinary usage notion of income would not extend to it and there is no other relevant specific provision of the Assessment Act.

1.75 Apart from the operation of s. 27B, lump sum compensation for loss of office or employment would not ordinarily be within the base of the income tax. It may yet be held that an office or employment can be a revenue asset of what would be a business or profession of holding offices or employments. But this is a remote prospect. Compensation for the loss of the office or employment would be seen as having at least kinship with a capital gain. Section 27B thus operates, as it does in relation to a lump sum superannuation benefit, to bring to tax an amount that would not otherwise be taxed. The operation of s. 27B is further considered in [2.408], [2.419] and [4.138]ff. below.

1.76 The Asprey Committee, in Chapter 21 of its Full Report, proposed the inclusion in the income tax base of the whole of lump sum retirement benefits and compensation for loss of office or employment. It did, however, propose special transitional provisions, so as to recognise existing expectations, and continuing provisions to give special relief against bunching. The proposals are some of the background of the
amendments to the law made in 1984, which introduced s. 27B.

Compensation for injury to person or reputation received in a lump sum

1.77 So far as the compensation is for income receipts, for example wages or salary already lost, compensation for injury to the person could be within the base of the Australian income tax. Inclusion in the base of any part of compensation for injury to the person will however generally be precluded by the principle in Allsop (1965) 113 C.L.R. 341 discussed in [2.558]ff. below, which stands in the way of the dissection or apportionment of a lump sum receipt which includes a non-income element so as to isolate the income element and bring it to tax.

1.78 In other respects a lump sum receipt for injury to person to reputation is not within the base of the Australian income tax. So far as it represents compensation for loss of earning capacity, the lump sum receipt is a gain from the realisation of human capital. It is a capital gain, and one which it might be difficult to embrace within a tax on capital gains. The problem would be to identify the gain. It may be asked what expenses, otherwise seen as private or domestic, would be regarded as costs of the human capital? The matter was considered by the Asprey Committee (Full Report, paras 7.34–7.40) but no recommendation for change was made.

1.79 Simons, Kaldor and the Canadian Royal Commission would presumably wish to see compensation for loss of earning capacity included in an income tax base. There is some reference to damages in the Canadian Report of the Royal Commission on Taxation, Vol. 3, pp. 63, 69, but no adequate discussion.

1.80 The compensation may include amounts in respect of non-economic loss—for pain and shortened expectation of life or for ridicule suffered. Lump sum receipts in respect of such loss are not within the Australian income tax base and the Asprey Committee did not propose any extension to include them. There is no indication of how Simons, Kaldor and the Canadian Royal Commission would regard such items.

Non-money accretions to spending power

1.81 Non-money accretions may take these forms:

(a) benefits is kind and valuable rights derived by the taxpayer;  
(b) flows of satisfactions yielded by property owned by the taxpayer; and  
(c) goods produced by the taxpayer for his own consumption, or services performed for himself by the taxpayer.
The principal illustrations of non-money accretions in the form of benefits in kind and valuable rights are afforded by the fringe benefits that an employee receives from his employer. They are considered in [2.30]ff. and [4.38]ff. below. The inclusion of such items, in the amount of their “value to the taxpayer” which may be greater than their realisable value, is provided for in s. 26(e) of the Assessment Act. The operation of that provision is, however, now qualified in its application to benefits in the form of housing by s. 26AAAA and s. 26AAAB. The operation of s. 26(e) is also qualified, in relation to employee share acquisition schemes, by s. 26AAC.

Where a benefit in kind or a valuable right is derived otherwise than in respect of an employment or rendering of services, the item can be within the base of the Australian income tax only to the extent of its realisable value. The realisable value may be little or nothing, though the item has significant value in the sense of what a person in the position of the taxpayer would have been prepared to pay to obtain it. In the result, accretions to spending power which the taxpayer has derived and which the comprehensive tax base would require to be included, are not included in the base of the Australian income tax.

Setting the scope of the notion of benefits in kind and valuable rights derived by a taxpayer, poses problems which may indicate that the comprehensive tax base, as a measure of the appropriateness of the law's definitions of income, may itself require definition. There is a difference, one would think, between a home provided rent-free by an employer, and a flat in a building in which the caretaker of that building is required to live and for which he is not charged any rent. In the case of the caretaker, there is a question of how much of the value of the flat is a benefit, and how much is simply an enjoyment inherent in performing the duties of the employment. The latter is referred to later in this Volume as a “condition of employment”. Simons gave some attention to the problem but offered no means of separating benefit from condition:

“A similar difficulty arises with reference to receipts in the form of compensation in kind. Let us consider here another of Kleinwächter's conundrums. We are asked to measure the relative incomes of an ordinary officer serving with his troops and a Flügeladjutant [Aide-de-Camp] to the Sovereign. Both receive the same nominal pay; but the latter receives quarters in the place, food at the royal table, servants, and horses for sport. He accompanies the Prince to theatre and opera, and, in general, lives royally at no expense to himself and is able to save generously from his salary. But suppose, as one possible complication, that the Flügeladjutant detests opera and hunting.

The problem is clearly hopeless. To neglect all compensation in kind is obviously
inappropriate. On the other hand, to include the perquisites as a major addition to the salary implies that all income should be measured with regard for the relative pleasurableness of different activities—which would be the negation of measurement. There is hardly more reason for imputing additional income to the Flügeladjutant on account of his luxurious wardrobe than for bringing into account the prestige and social distinction of a (German) university professor. Fortunately, however, such difficulties in satisfactory measurement of relative incomes do not bulk large in modern times; and, again, these elements of unmeasurable psychic income may be presumed to vary in a somewhat continuous manner along the income scale.” (*Personal Income Taxation*, p. 53.)

The phenomenon of expense account living may lead one to wonder if Simons is correct in saying that the difficulties the describes do not bulk large in modern times.

1.85 The principal illustration of non-money accretions in the form of flows of satisfaction yielded by property owned by the taxpayer, is the imputed rent of an owner-occupied house. A comprehensive tax base would include the value of the services a house performs for its owner. The base of the Australian income tax does not include imputed rent. It was not always so. From 1915 to 1923, 5 per cent of the capital value of an owner-occupied residence was included in the base of the income tax. Deductions were allowed against this amount for expenses by way of repairs, rates and land taxes, and mortgage interest. This inclusion depended on express statutory provision. It is assumed that the ordinary usage notion of income does not include imputed rent, though the reason is not very apparent. One might point to an absence of derivation in that there has been no receipt from another person, and no realisation of property. Consumption, it would be said, is not realisation.

1.86 Clearly there is a substantial inequity in the treatment of homeowners and taxpayers who are tenants, if imputed rent is not included in the base. But there are arguments against inclusion. Some of these concern the need for valuation in fixing the amount of the imputed rent. Others concern the liquidity difficulty and hardship for a taxpayer who, for example, may be a widow continuing to occupy a large family home. The Asprey Committee did not recommend the extension of the income tax base to include imputed rent, though it did propose a limited deduction of rent paid by a person who occupies his home as a tenant. (*Full Report*, paras 7.11, 7.42–7.57.)

1.87 There are other cases of non-monetary accretions in the form of flows of satisfaction yielded by property owned by the taxpayer. The Asprey Report refers to works of art and consumer durables as yielding flows of satisfaction, but it did not propose extension of the tax base to include such
flows, pointing to the administrative problems that would result from the extension.

1.88 The theory of a comprehensive tax base would suggest that there should be included in the base the value of goods produced by a taxpayer for his own consumption, and the value of services performed by a taxpayer for himself. But Simons, Kaldor and the Canadian Royal Commission saw the need to put reins on logic so that it might not overrun what was administratively feasible, and indeed, overrun the equity that a comprehensive tax base would aim to serve. Taxing the value of self-produced goods and self-rendered services might be thought unfair, when the enjoyment of leisure by those who pay others to produce and render services is not taxed.
Chapter 2: Income under the Assessment Act Adopting Ordinary usage

2.1 This chapter is devoted to exploring the contribution to the meaning of income for purposes of the Assessment Act which is made by the ordinary usage meaning of the word as explained in judicial decisions. Sometimes this ordinary usage meaning is taken into the meaning in the Act simply through the word “income” in s. 25(1). Sometimes a specific provision of the Act will confirm the ordinary usage meaning as part of the Act's meaning. At other times a specific provision will deny that the ordinary usage meaning is part of the Act's meaning, or limit or modify the ordinary usage meaning that would otherwise be part of the Act's meaning. At least this is the view taken in this Volume, which proceeds on the single meaning analysis explored earlier in Chapter 1. There is an alternative view, based on the two meanings analysis, which would say that no specific provision has this kind of operation. Indeed, the alternative view may be that no specific provision can have this kind of operation. At most, a specific provision can make what is income by ordinary usage exempt income for purposes of the Act.

2.2 Without excluding, limiting or modifying the ordinary usage meaning that would otherwise be part of the Assessment Act's meaning, a specific provision may add to the meaning of income for purposes of the Act.

2.3 In the following treatment of the ordinary usage meaning, the exclusions limitations and modifications made by specific provisions in the process of receiving the ordinary usage meaning into the Act are described, and the specific provisions identified. Some of the specific provisions which add to the meaning of income in the Act are also noted, where this will assist in showing the scope of the ordinary usage meaning received into the Act. The specific provisions are listed and further dealt with in Chapters 3 and 4.

2.4 The method adopted in what follows, after a general description, is to formulate a series of propositions which endeavour to state the ordinary usage meaning. As one might expect, the formulation cannot be expressed in definitive terms. In some instances a proposition is no more than a phrase taken from some judicial statement, to which substance can be given only by illustration.

2.5 The propositions attempt to state the meaning of income not in some abstract sense, but as the income of a particular taxpayer. A notion of an item that is inherently income could be asserted. And the drafting of the Assessment Act lends some support to such a notion. Section 25(1), it will
be recalled, refers to “income derived”, which may suggest that an item can be income without the element of derivation. There is, however, clear authority that the character of an item as income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it would have had if it had been derived by another person (Proposition 3 below). Section 25(1) must be read in the light of this authority.

2.6 A description of ordinary usage income which will bring together all the propositions that follow would be:

An item is income of a taxpayer, in the amount of its realisable value, if it has been derived by him and the item is a gain derived in circumstances which give it in other respects an income character.

2.7 This description summarises a number of propositions:

**Proposition 1:** An item of an income character is derived when it has “come-home” to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation.

**Proposition 2:** An item of an income character that has been derived will be income in the amount of its realisable value.

**Proposition 3:** The character of an item as income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it would have had if it had been derived by another person.

**Proposition 4:** To have the character of income an item must be a gain by the taxpayer who derived it.

**Proposition 5:** There is no gain unless an item is derived by the taxpayer beneficially.

**Proposition 6:** There is no gain if an item is derived by the taxpayer from himself: the principle of mutuality.

**Proposition 7:** There is no gain if an item is derived by the taxpayer as a contribution to capital.

**Proposition 8:** A gain which is a mere gift does not have the character of income.

**Proposition 9:** A mere windfall gain does not have the character of income.

**Proposition 10:** A capital gain does not have the character of income.

**Proposition 11:** A gain which is one of a number derived periodically has the character of income.

**Proposition 12:** A gain derived from property has the character of income.

**Proposition 13:** A gain which is a reward for services rendered or to be rendered has the character of income.
Proposition 14: A gain which arises from an act done in carrying on a business, or from the carrying out of an isolated business venture, has the character of income.

Proposition 15: A gain which is compensation for an item that would have had the character of income had it been derived, or for an item that has the character of a cost of deriving income, has itself the character of income.

2.8 Proposition 1 asserts the requirement of derivation, and Proposition 2 states the method by which the amount of income derived is to be measured. The remaining propositions are concerned with the income character in other respects of an item derived. Proposition 3 asserts that the character as income of an item must be judged in the circumstances of the derivation of the item by the taxpayer. Proposition 4 asserts the requirement that to be income an item must involve a gain by the taxpayer. Propositions 5, 6 and 7 describe circumstances in which there is no gain, and where there cannot therefore be income. There is no gain by a taxpayer who does not derive the item beneficially. There can be no gain if an item is derived by the taxpayer from himself. At least this is a proposition asserted in some of the authorities. It is adopted only to begin a discussion that leads to other propositions which are a more helpful explanation of a group of cases which are said to express the principle of mutuality. Proposition 7 is expressed in terms of a phrase used in some of the cases. Again the proposition is adopted in order to begin a discussion that leads to other propositions which are more helpful. Propositions 8, 9 and 10 are negative propositions which identify gains derived which do not have an income character. They are strictly unnecessary, but will be found in the authorities as descriptions of gains derived which are not gains that are covered by the remaining propositions, that is, Propositions 11, 12, 13, 14 and 15. These remaining propositions are positive propositions, and any gain derived must be within one of them if it is to have the character of income. Propositions 8, 9 and 10 are not intended as an exhaustive statement of gains derived which do not have an income character. The fact that none of these propositions applies to designate a gain derived as non-income, does not mean that the gain is income. It must have the character of income under one of the positive propositions.

2.9 Each of the propositions is now examined in turn, and the effect on the proposition of specific provisions of the Assessment Act in excluding limiting or modifying it as a statement of the meaning of income for purposes of the Act is considered.

Proposition 1: An item of an income character is derived when
it has “come-home” to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation

2.10 Derivation of an item is the subject of Pt III of this Volume. For the most part, the law expresses an ordinary usage notion of derivation of a receipt. It will be seen that a distinction is to be drawn in this regard between the case where a taxpayer in relation to an item is to be regarded as on a cash basis of tax accounting, and a case where he is on an accruals basis.

2.11 The law determines which basis of accounting is appropriate, and there is a substantial body of principles and rules as to what amounts to ordinary usage derivation on each basis. The phrase “comes-home” is adopted in Proposition 1 as a convenient description of a derivation within that body of law.

2.12 It will be seen, too, that there are specific provisions which determine what is derivation in particular contexts. On the analysis adopted in this Volume, those provisions are aspects of the meaning of income for purposes of the Assessment Act. They may confirm, limit or modify ordinary usage derivation, or perhaps add other occasions of derivation. In the latter case, there will be risks of multiplying items which are income, and a need for law which will obviate multiple taxation.

2.13 Generally an item derived is income as to the whole of it, because it is wholly a gain, and to this extent it may be correct to say that ordinary usage income items are receipts. But on the view taken in this Volume there are occasions when an item derived is income only in part, because it is only in part that it represents a gain. Thus a gain which arises from the sale of trading stock at a profit will by ordinary usage be only part of the receipt of the proceeds of sale. It will be seen, however, in Chapter 14 that this is a context where express provisions have modified the ordinary usage notion of income so that the proceeds of sale are treated as income as to the whole of them, and there are compensating modifications to the notion of deductible expense. Where the sale is of property other than trading stock, and the sale is an act in carrying on a business or the carrying out of an isolated business venture, the proceeds of sale are income only to the extent of that part which represents a profit. And there are other illustrations, for example in the area of gains arising from movements in rates of exchange of currencies, where an item is income only as to part.

2.14 The principles which determine the derivation of an item express a general concept of realisation as essential to income derivation. Where the item is an increase in the value of property, it would be possible to regard an unrealised gain, for example an increase in the value of land which a
taxpayer owns, as income, though most opinion would be opposed to a change in the law so as to require that an increase in value be treated as income. There is, however, an election open under the trading stock provisions of the Assessment Act to treat an unrealised gain as income, and to this extent ordinary usage is displaced. The election is dealt with in Chapter 14.

2.15 In Chapter 10 the distinction between cash accounting and accruals accounting is explored in some detail. One aspect of that distinction may be noted here: there is no derivation on a cash basis if the taxpayer merely comes to have a right to receive money. There must be an actual or constructive receipt of the money. Where the taxpayer is on an accruals basis in relation to the item, the arising of a right to receive money may however be a derivation. Generally where there is a right to some benefit or to property other than money there cannot be a derivation, whether the taxpayer is on accruals or cash, until the benefit or property has come to be vested in the taxpayer. Property for this purpose may, it seems, include a chose in action. Thus the taxpayer in Abbott v. Philbin [1961] A.C. 352 and the taxpayer in Donaldson (1974) 74 A.T.C. 4192 who came to have rights to options over shares were regarded as having derived those options at the time when a distinct set of legal relations constituting the options came into existence. There is, it seems, a difference for tax purposes between a contractual right to an issue of options which will not involve a derivation, and the actual issue of options which will involve a derivation, though Lord Denning (dissenting) in Abbott v. Philbin took a different view. He equated the options with standing offers, for example an offer under an employment contract to supply goods at a discount. An employer may be bound to maintain his standing offer, but it would be assumed that there is no derivation by the employee until he accepts the standing offer. The standing offer analysis will be the preferable analysis in most circumstances not involving options. Thus a taxpayer may be entitled under his contract, after some period of service, to a free ticket to travel on the airline conducted by his employer. There will be no derivation of income until the benefit of travel has been actually provided by his employer.

2.16 The majority view in Abbott v. Philbin, followed in Donaldson, may possibly be explained on the ground that an option gives some kind of proprietary interest to the person holding the option, though observations will be found in Abbott, made by some judges, which suggest that the coming into existence of a right to property which subsists only in contract may be a derivation. Where a chose in action is treated as property acquired by a taxpayer, it will be held to be derived notwithstanding that
there are elements of contingency in relation to the chose in action which would preclude a derivation by an accruals basis taxpayer in relation to a right to money. A derivation constituted by the arising of a right to money will be such only where there is no contingency. A derivation constituted by the vesting of a chose in action in the taxpayer will be such even though the rights given by the chose are contingent on events yet to occur. Thus in Donaldson the options were income notwithstanding that they were exercisable only if the taxpayer completed periods of service to his employer in the future.

2.17 Abbott v. Philbin, Donaldson, and another Australian case, Constable (1952) 86 C.L.R. 402, are the most important cases on the significance of the moment of derivation as an aspect of income by ordinary usage. Clearly, where a taxpayer is on a cash basis in relation to the item and receives cash there is a derivation, and there is no further derivation when he converts the cash into some other kind of property, for example by buying goods with it. Abbott and Donaldson rejected a conclusion that there was income derived, as income from services, at the time of the sale of the options or at the time of the exercise of the options. The exercise of options in these circumstances is no different from the purchase of goods with cash already derived as income. The exercise of the options is simply the “exploitation of a valuable right”: Abbott [1961] A.C. 352 at 379, per Lord Radcliffe. Even if it be held that the exercise gives rise to a derivation, it is not a derivation in circumstances that will give it an income character as a reward for services. In Constable there was no derivation by the taxpayer until he actually received a payment from the superannuation fund. At that time the circumstances gave it the character of a simple payment from a fund in satisfaction of his rights in the fund: there was no longer a character as a reward for services attaching to that part of the receipt that could be traced to a payment into the fund by the employer.

2.18 It does not however follow that the exercise of options may not be a step in a transaction of acquisition and subsequent sale of shares which will produce a profit which is income, the character of income flowing from Proposition 14. In such event it is necessary to ensure that the profit does not include any part of the value of the options at the time they were applied in the acquisition of the shares. In calculating the amount of the profit there should be a subtraction of the value of the options at the time of their exercise. Executor Trustee & Agency Co. of S.A. Ltd (Bristowe's case) (1962) 36 A.L.J.R. 271 is relevant though it involved income by specific provisions in s. 26(a) (the predecessor of s. 25A(1)), and not ordinary usage income. Bath & West Counties Property Trust Ltd v. Thomas [1977] 1 W.L.R. 1423 may be a more relevant authority.
2.19 The discussion so far assumes that the acceptance of the offer of the options is not a step in a transaction of acquisition and subsequent sale of the options, or a transaction of acquisition of the options, exercise of them, and subsequent sale of the shares, which may produce a profit that is income. The character of income would flow from Proposition 14 or s. 25A (1). There could be a derivation of profit in the sale of the options, or in the sale of the shares obtained in the exercise of the options, though probably not in the mere acquisition of the options and their exercise. If there is a derivation of a profit which is income, it will be necessary to ensure that the profit does not include any part of the value of the options that were income at the time they were acquired. In Bristowe's case the commencement of the relevant transaction involving a derivation of income occurred at the time of the exercise of the options. If, however, the transaction commences with the acquisition of the options, there should generally be a subtraction of the value of the options at the time of acquisition, in computing the profit. Value for this purpose will be the market value and not the value to the taxpayer. However, the protection of the taxpayer against double taxation will require that if he has been taxed under s. 26 (e) on the value to the taxpayer—a concept explained in [2.33] below—and this is higher than market value, he will be entitled to a subtraction of the higher amount.

2.20 There is a perhaps unexpected consequence of the principle in Bristowe's case. The value of an option is in part extinguished by the exercise of it. The market value of an option to acquire at par a share whose market value is $1 more than par, will be more than $1, at least if the option is exercisable within a significant period of time. It follows that the exercise of the option and sale of the share may give rise to a loss rather than a profit, though there is no fall in the value of the share. Indeed it may give rise to a loss even though there is an increase in the value of the share.

2.21 The exercise of options may be a step in a transaction of acquisition and subsequent sale of shares which will produce a profit that is income under s. 26AAA. Bristowe's case will be applicable in determining the cost of the shares. There is a deemed purchase of the shares under s. 26AAA (1) (d). The acquisition of a share by way of a subscription of capital is a deemed purchase. Presumably it is the value of the options at the time of exercise of the options that will determine this element of cost. It may be possible however to see the acquisition of the options and the exercise of the options as a two-step purchase of the shares, completed at the time the options are exercised. The possibility of a two-step acquisition is endorsed by the majority in Steinberg (1975) 134 C.L.R. 640, a case concerned with
s. 26(a) (the predecessor of s. 25A(1)). In which case it is the value of the options at the time of their acquisition, or, as explained in [2.19] above, their value to the taxpayer at the time of their acquisition, that will govern.

2.22 The argument of the Revenue in *Abbott v. Philbin* [1961] A.C. 352 came near to an assertion that because, as the Revenue submitted, there was no derivation at the time the offer of the options was accepted, there was a derivation at the time the options were exercised and shares acquired. Such a derivation would extend to the value of the options, as found in the value of the shares, less the cost of the options. *Constable* (1952) 86 C.L.R. 402 demonstrates that such a proposition is not tenable. The case is authority than an item which would have been income had the element of derivation been present at some earlier time, will not be income at a later time when it is in fact derived unless the circumstances then obtaining give it the character of income. In *Constable* there was no derivation, in the opinion expressed, obiter, by the majority of the court, at the time the employer paid an amount to the trustee of the superannuation fund. At that time the employee had no right, not even a contingent right, to any specific amount. When the trustee exercised his discretion so as to appropriate a specific amount to the employee, there might have been a derivation, but the circumstances did not give the amount the character of income. The relevant proposition would be Proposition 13. But the action of the trustee had changed the nature of the item from a reward for services paid by an employer, into an appropriation of capital by a trustee in the exercise of his discretion as trustee. Whether there was in truth a derivation by the employee on the exercise of the discretion would raise the question whether the arising of a right to money can ever be a derivation by a cash basis taxpayer. There was a derivation in the circumstances of *Constable* when there was an actual payment out by the trustee to the employee. At this time, however, the original payment to the trustee by the employer, had, a fortiori, lost its character as income. There was now no more than an historical connection between the amount received and the rendering of services.

2.23 *Abbott v. Philbin* must be regarded as a decision that the condition on which the options were issued, namely, that they were only exercisable while Abbott remained in the service of the company, did not relate the shares acquired in the exercise of the options with service to the company so as to make them a reward for services. It was arguable that there had been two derivations of income, one when the options were acquired and another when they were exercised. The derivation in the latter case would be confined to the further value of the options, now to be found in the shares, beyond their value at the time the options were acquired. But the
decision appears to be that the condition imposed on the exercise of the right did not give a sufficient connection between the increase in the value of the options and the services, so as to make the increase in value, when derived in the acquisition of the shares, a reward for further services. In *Donaldson* (1974) 74 A.T.C. 4192 the options were not exercisable until various periods of service had been completed. Bowen C.J. in Eq. did not have to decide whether an increase in the value of the options, derived in the acquisition of the shares on the exercise of the options, was a reward for services. There is a difference between the defeasibility of the options in *Abbott* and the contingency operating in *Donaldson*, but it may be that the difference is not enough to justify a difference in result.

2.24 The concept of derivation as an element in the notion of income by ordinary usage is confirmed, limited or modified by a number of specific provisions of the Assessment Act. A number of other specific provisions add to the circumstances which will give an item derived an income character, and, for this purpose, may create their own notions of derivation. Reference is made to these specific provisions later in this chapter, and some are the subject of extensive treatment in Chapter 3 and in Part III.

2.25 Section 26AAC inserted in the Assessment Act in 1974, materially affects the ordinary usage notion of income as expressed in *Abbott v. Philbin* [1961] A.C. 352 and *Donaldson* (1974) 74 A.T.C. 4192, in the particular context of acquisition by employees of shares or rights to shares. Section 26AAC calls for discussion in connection with Proposition 3, and it is dealt with again in Chapter 4. A detailed statement of the tax accounting appropriate in the operation of s. 26AAC is given in [12.165]ff. below. For the present, discussion is confined to the effect of s. 26AAC on the ordinary usage notion of derivation. The section is limited in its operation to acquisitions of shares or rights to shares under a scheme for the acquisition of shares by employees, as defined in subs. (1). Its effect is to bring about a derivation of income when the shares become free of restrictions on the right to dispose, or the rights to shares are disposed of. It thus brings about the result for which the Revenue argued in *Abbott*. But the method by which these results is sought is curious. Section 26(e) which, it will be seen later in this chapter and in Chapter 4, is a partial statement and partial extension of the ordinary usage notion of income in relation to benefits arising from the rendering of services, is expressly excluded by s. 26AAC(10), but there is no express exclusion of the ordinary usage notion of income imported by s. 25(1). On the single meaning analysis, an acceptable correlation of the sections is possible. Section 26(e) would be treated as a code expressing exclusively in the absence of a contrary provision the meaning of income in relation to
benefits arising from the rendering of services. The exclusion of s. 26(e) would thus leave s. 26AAC to operate alone. On a two meanings analysis, the law in Abbott and Donaldson continues to apply, so that there are successive derivations, once by ordinary usage and then by s. 26AAC, the second derivation being, generally, of a greater amount, but embracing the first. Successive derivation in this way is not dealt with in the section and double taxation would need to be corrected by some general principle as yet undeveloped in the interpretation of the Assessment Act.

2.26 Subsections (11) and (12) of s. 26AAC contemplate other problems of multiple derivation, arising from the operation of both s. 26AAC and the ordinary usage notion, or arising from the operation of both s. 26AAC and another specific provision, for example s. 25A(1) or s. 26AAA. The fact that two provisions of the Assessment Act make the same item income does not mean that it is income as to double its amount. These problems of multiple derivation are the subject of detailed examination in [12.170]-[12.177] below.

2.27 In the formulation of Proposition 1 the observation is included that illegality, immorality or ultra vires does not preclude derivation. But the presence of one of these factors is not irrelevant. It will be seen in Chapter 11 that where the taxpayer is on an accruals basis in relation to the item, legal entitlement is said to be necessary if there is to be a derivation in advance of actual receipt. Illegality, immorality or ultra vires may prevent legal entitlement arising so that derivation would be deferred until actual receipt. The view of this Volume developed in Chapter 11 is that the arising of a claim of right should be sufficient to bring about a derivation on an accruals basis, and legal entitlement should be unnecessary. To the extent that illegality, immorality or ultra vires may in particular circumstances suggest that no claim of right has been made, it will be relevant to the question of derivation.

2.28 Ordinary usage income does not include the value of the services rendered to a taxpayer by the house he owns and occupies, or the value of self-rendered services or self-produced goods. This is probably best explained in terms of the absence of the element of derivation. There must be a gain which has a source in an obligation undertaken by another, or in a payment of money or transfer of property by another. Otherwise the notion of “coming home” is not satisfied.

2.29 There will be a parallel denial that the value of self-rendered services, or the value of the work done in production of self-produced goods, can be a deduction as an outgoing incurred. If an income tax system were to allow, as a cost of repairs, the value of the labour of an owner who repairs the house which he has let to a tenant, it would be necessary to treat the

**Proposition 2: An item of an income character that has been derived will be income in the amount of its realisable value**

*2.30* In some authorities, including Tennant v. Smith [1892] A.C. 150, a proposition is asserted that an item may be income only if it is money or something that can be turned into money. A proposition so formulated must be taken to be rejected by Abbott v. Philbin [1961] A.C. 352. The fact that an item has no realisable value at the time of derivation does not prevent that item having the character of income. There will be no amount of income, but there is none the less an item of income, and the mere subsequent conversion of that item into money or an item that has a money-value is not a derivation of an amount of income. In Abbott Viscount Simonds said (at 366): “. . . it is really irrelevant whether a value could be ascribed to [the option] or not. If it had no ascertainable value then it was a perquisite of no value . . . .” His observation might be reframed thus: there was an income item derived, but there was no amount of income.

*2.31* In one respect, the notion of realisable value for purposes of Proposition 2 has been given a wide meaning in United Kingdom authority: Heaton v. Bell [1969] 2 W.L.R. 735. In that respect it is wider than the meaning suggested by the judgment of Bowen C.J. in Eq. in Donaldson (1974) 74 A.T.C. 4192 at 4207 in relation to the notion of “value to the taxpayer” in s. 26(e): “what a willing but not anxious purchaser might pay for [the item].” Heaton v. Bell, admittedly involving a special situation, would treat as realisable value what a taxpayer might obtain for the item by surrendering it to the person from whom he received it.

*2.32* Proposition 2 none the less opens up the prospect that gains, in the sense of additions to a taxpayer's command over goods and services, may fail to be included in the income tax base. There may be a substantial increase in command over goods and services—in the free use of a house or car, or the enjoyment of a subsidised meal—but because that command cannot be passed to another, there will be no amount of income brought to tax. Tennant v. Smith involved the free use of a flat which could not be assigned or sublet. Cooke and Sherden (1980) 80 A.T.C. 4140 involved a free holiday for the taxpayer and his family. Limiting the amount of income to realisable value may be explained on the ground that it provides a determinate test of amount, and ensures that the taxpayer will be able to obtain money with which to pay the tax in respect of the item. But it
encourages planning by which non-money income is substituted for money income. The provision of “fringe-benefits” instead of money may give a taxpayer the same enjoyment of resources as he would have obtained by spending money-income, but there may be a vital difference in tax consequences.

2.33 Tax planning of this kind has been qualified by the specific provision in s. 26(e), which will bring in as an amount of income “the value to the taxpayer” of an item derived which has the character of income, where the item is a benefit allowed, given or granted to the taxpayer in respect of any employment or services rendered by him. Section 26(e) is considered in this chapter in connection with Proposition 13, and again in the treatment of specific provisions in Chapter 4. It may be noted here that the meaning of the phrase “value to the taxpayer” was examined by Bowen C.J. in Eq. in Donaldson (1974) 74 A.T.C. 4192 at 4207 where he said: “I consider it is appropriate in ascertaining value to the taxpayer to determine what a prudent person in his position would be willing to give for [the item] rather than fail to obtain [it].” It may also be noted that s. 26(e) operates only in relation to benefits given in respect of an employment or services rendered by the taxpayer. A retailer does not render services to a manufacturer by selling goods acquired from the manufacturer (Cooke and Sherden), and s. 26(e) will not apply in relation to a free holiday provided by the manufacturer. A landlord may let a flat, taking in return professional services from his tenant, and s. 26(e) will not be attracted. A creditor may enjoy the use of a television receiver provided by a finance company to which he has lent money and s. 26(e) will not be attracted: Dawson v. C.I.R. (N.Z.) (1978) 78 A.T.C. 6012.

Proposition 3: The character of an item as income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it would have had if it had been derived by another person

2.34 The leading authority supporting this proposition is Federal Coke Co. Pty Ltd (1977) 77 A.T.C. 4255. In that case the holding company of the taxpayer released a customer from a contract—by which the customer agreed to purchase coke from the holding company—in exchange for a payment to the taxpayer. The taxpayer was the producer of the coke. If the payment had been made to the holding company, the holding company would very likely have derived income. The relevant principles are explained in relation to Propositions 14 and 15. But the payment had been made to the taxpayer and the circumstances of the derivation of the item by
the taxpayer did not give an income character to it. Federal Coke, in this respect is foreshadowed by the judgment of Latham C.J. in Gair (1944) 71 C.L.R. 388 at 393, quoted in [13.24] below. On the facts of Federal Coke, there may be some grounds for thinking that there had been a derivation by the holding company, and an application of the item so derived by a payment to the taxpayer, in which case there would be room for a submission that the holding company had derived income. Aspects of the ordinary usage notion of derivation and the interpretation of s. 19 which may express an ordinary usage notion of constructive derivation, would be raised. These aspects are discussed in Chapter 11.

2.35 It is possible that a stipulation in a contract for payment to another, or for the provision of some benefit to another, will avert a derivation by the person making the stipulation, and the person who receives the payment or benefit will be unaffected by the circumstances which would have given an income character to a derivation by the person making the stipulation. It may be expected that the stipulation will require payment, or the provision of the benefit, to an associated person—a subsidiary company as in Federal Coke, or a relative of the person making the stipulation—and there is scope for tax planning. The matter is discussed in Chapter 13. Two specific provisions have a bearing. Section 26(e), to which reference was made in connection with Proposition 2, does not directly displace the ordinary usage notion as expressed in Proposition 3. But the broad words used in the provision, more particularly “benefits . . . given”, may defeat the kind of planning suggested by Federal Coke. School fees paid by an employer in respect of an employee's children may involve a benefit given to the employee in the form of relief from a payment the employee would otherwise have made himself. The other specific provision is s. 26AAC, to which reference was made in connection with Proposition 1. The section displaces the ordinary usage principles of derivation flowing from Abbott v. Philbin [1961] A.C. 352 and Donaldson (1974) 74 A.T.C. 4192 in the context of schemes for the acquisition of shares by employees. In addition, it displaces the ordinary usage principle expressed in Proposition 3 where shares or rights to shares are acquired, not by an employee whose services would give an income quality to shares or rights he acquired, but by a relative of that employee. Section 26AAC provides, by the operation of subs. (1), that in these circumstances the relative derives income.

2.36 Proposition 3 has important implications where gains are the subject of an assignment, or are derived through a trust or partnership intermediary. These implications are considered more closely in Chapter 13. The very phrase “assignment of income” sits poorly with Proposition 3. Where property from which the assignor derives gains, is assigned, and
gains now flow to the assignee, no conceptual difficulties arise. The interest, dividends, rent or other passive gain items are now derived by the assignee from his property and Proposition 12 is attracted. Where only gains flowing are assigned, conceptual difficulties do arise. If the future passive gain items assigned were the subject of what might be called present rights in the assignor to future property, it may be possible to regard those items as income of the assignee when derived by him, on the ground that they are gains derived from the present rights to the future gains, so that Proposition 12 is attracted. Where, however, the assignment is of expectancies, which are not the subject of present rights held by the assignor, the flows of gains to the assignee can have the character of income only in virtue of their periodicity under Proposition 11.

2.37 Division 5 (relating to partnerships) and Div. 6 (relating to trusts) are necessary to overcome implications of Proposition 3. In the circumstances of derivation of an item by a trustee, there would not, apart from Div. 6, be income, because there would not be a gain by the person who derived the item—Proposition 4 would deny an income character. Section 95 overcomes the consequences of Propositions 3 and 4, by deeming the trustee to be a “taxpayer” for purposes of making a calculation of “net income” of the trust estate. This deeming, it is assumed, supplies an element of beneficial derivation which is essential to give the character of income to the items derived by the trustee. Other sections of Div. 6—ss 97, 98, 99B and 101—supply derivations by the beneficiaries in virtue of their present entitlements and actual distributions to them. In the absence of these provisions there might be no derivations by beneficiaries, at least in the present entitlement situations. And there might be a derivation by a beneficiary to whom a distribution is made, that none the less lacks an income character in the circumstances of its derivation.

**Proposition 4: To have the character of income an item must be a gain by the taxpayer who derived it**

2.38 Proposition 4 asserts a general principle which will make the tax law concept of income accord, in this respect, with the concept of income asserted by those economists who identify income with accretions to economic power. Proposition 4 is spelt out in Propositions 5, 6 and 7. It is spelt out, so far as Propositions 6 and 7 are concerned, in the language of judicial decisions expounding the ordinary usage notion of income, but the underlying reason why the items are not income is, it is submitted, the absence of gain.

2.39 Proposition 4 is not in its terms expressed in judicial decisions.
Judicial elaboration of the ordinary usage notion of income, at least in its earlier history, has been content to illustrate rather than to look for underlying reason, though the generalisation that income is “what comes in” has been offered, more as a confession of a failure to find reason than as a reflection of some insight. The judgments of the Federal Court in Everett (1978) 78 A.T.C. 4595 do not openly embrace Proposition 5, which is the most obvious expression of Proposition 4. Indeed the members of the court do not appear to be entirely persuaded that a trustee, who cannot rely on some express provision of the Assessment Act such as s. 96, may not derive income by virtue of his receipts as trustee which will be taxed to him as additions to his undoubted income. Proposition 5 is not openly embraced by the Full High Court in Everett (1980) 143 C.L.R. 440 but it does appear to be assumed.

2.40 Proposition 4 is openly challenged by some of the decisions in relation to Proposition 11, which assert that a taxpayer may purchase a series of periodical receipts and the whole of these receipts be income, notwithstanding that they are not gains: they reflect merely a change in the form in which economic power is held. It will be seen that the consequences of these decisions is substantially corrected by s. 27H, and there is some reluctance by the courts to hold that purchased receipts are income as periodical receipts. That reluctance reflects a view, sometimes explicit, that a tax liability should not be attracted by a simple change in the form of economic power. Proposition 4 is also challenged by a number of decisions in regard to the taxation of income derived from property—Proposition 12—more especially, royalty receipts, and by a number of decisions in regard to the taxation of compensation receipts—Proposition 15.

Proposition 5: There is no gain unless an item is derived by the taxpayer beneficially

2.41 Proposition 5 is the most obvious expression of Proposition 4, and the fact that it is not openly embraced is an indication that judicial elaboration of the ordinary usage notion of income has been timid about seeking underlying reason. Everett (1978) 78 A.T.C. 4595, in the Federal Court, at times reflects a view that would reject Proposition 5, and assert that a trustee derives income though he does not take beneficially: he must then rely, if he can, on some express provision, notably s. 96, to preclude liability for tax. At other times Everett in the Federal Court reflects a view that would accept Proposition 5, while asserting that there are express provisions, notably ss 92 and 44, which will displace that proposition. On
this view, s. 92 will displace Proposition 5 in the context of derivation through a partnership intermediary. Section 44 will displace it in the context of derivation of dividends. Those sections will give rise to a liability to tax on a trustee, unless some other express provision, notably s. 96, excludes liability. Neither of these views has the authority of any judicial decision and they are rejected in this Volume.

2.42 Without Proposition 5, the ordinary usage notion of income would be left without underlying reason. The assertion that Proposition 5 is valid as a statement of the ordinary usage meaning of income, but is rejected, in the context described, by ss 92 and 44, calls for an explanation of why underlying reason should be rejected in these contexts.

2.43 The terms of s. 96 pose problems of interpretation. The section provides that “Except as provided in this Act, a trustee shall not be liable as trustee to pay income tax upon the income of the trust estate”. It will be noted that the phrase used is “the income of the trust estate” which, in its use in s. 97, is taken to refer to trust law income. Any liability to pay tax would be upon the “net income” (defined in s. 95(1)) of the trust estate. That aside, the section is concerned only with the trustee's liability “as trustee”. If Proposition 5 is denied, a trustee would be liable not “as trustee”, but, rather, notwithstanding the fact that he is trustee. Contrary to the view at times reflected in the Federal Court judgments in Everett (1978) 78 A.T.C. 4595 that s. 96 protects the trustee from a liability which will arise if Proposition 5 is incorrect, the section may, with equal if not greater force, support Proposition 5. It supports that proposition by dealing only with liability of the trustee “as trustee”, with the implication that the proposition protects the trustee against liability as a person deriving income.

2.44 If judicial recognition of Proposition 5 is sought, it may be found in the judgment of Dixon J. in The Countess of Bective (1932) 47 C.L.R. 417. The question was whether amounts paid to the appellant by the trustees of a trust fund were part of her assessable income. She took the amounts under some obligation requiring her to spend them in the maintenance and support of her daughter. Dixon J. said (at 423):

“The question is whether the payments to her form part of her assessable income. The income of the trust fund appears to have been included in the taxpayer's assessment upon the view that she took it beneficially, the statement of the purpose contained in the provision for maintenance amounting to no more than an expression of the donor's motive, or of his expectation. Its inclusion in her assessable income could be supported, if the statement of the purpose were understood as annexing to a gift to her a condition which she was bound to perform. Possibly, it might be supported also if the provision were construed as a gift of income to the taxpayer
subject to a charge for maintenance. But if either of these two constructions were adopted, a corresponding deduction should be allowed for expenditure upon maintenance, a deduction which would not, of course, necessarily amount to the same sum. On the other hand, if she is not an object intended to be benefited at all by the provision for maintenance, the payments ought not, in my opinion, to be included as assessable income of the taxpayer, although, if it appeared that she had appropriated to her own use an unexpended surplus after discharging her duty of maintaining her daughter, that surplus would be taxable as part of her income.”

The statement that if the appellant was not an object intended to be benefited at all by the provision for maintenance, the payment ought not to be included in her assessable income, is made as an assertion of general principle for which no express statutory support was necessary.

**Proposition 6: There is no gain if an item is derived by the taxpayer from himself: the principle of mutuality**

2.45 Proposition 6, the mutuality principle, is another expression of the idea of gain as an essential element in the ordinary usage notion of income. The language of the proposition, which refers to “an item derived by the taxpayer from himself”, is drawn from some of the cases, and is useful if not taken literally. The proposition may be seen as a particular application of Proposition 7, itself drawn from the cases and also an expression of the idea of gain.

2.46 Proposition 7 would say that a receipt by one person from another of money which must be applied in serving the purposes of the person paying, any surplus being returned to him, is generally not income of the receiver. There is no gain to the receiver unless the purposes of the person paying include a benefit to the receiver, in which event Proposition 7 will apply a qualification. Mutuality is an application of Proposition 7 in the context of a receipt by an association from one of its members.

2.47 Where the purpose of the member involves a benefit only to a third party, the application of Proposition 7 is clear. The association may receive money from a member to be applied for the benefit of a charity.

2.48 Where the association is a co-operative and the purpose of the member is to meet the cost of goods or services supplied to him by the co-operative, the member being entitled to have any surplus of what he pays over cost returned to him, the application of Proposition 7 is again clear. The return will need to be to the member as the person who paid the amount from which the surplus arose. It will be seen that the prospect of a distribution of the surplus among members generally will defeat the operation of the mutuality principle.
Where the association is a members' club and the club receives a subscription from a member to be applied for the collective benefit of all members in the provision of club facilities, the operation of Proposition 7 may not be quite so clear. There is an appearance of gain to the club which is overcome only by treating the club's apparent gain as a gain to each member. The effect of the payment of subscriptions by all members is that each member's interest in the club is increased by a like amount, and there is, in substance, a receipt from a member to be applied for the benefit of that member. The club's interests are identified with the interests of the members from whom the subscriptions are received. (Glasgow Corp. Water Commissioners v. I.R.C. (1875) 1 T.C. 28 at 50 per Lord Deas; New York Life Assurance Co. v. Styles (1889) 14 App. Cas. 381 at 393-4, per Lord Watson.) The receipts by the club are receipts by members from themselves. Treating receipts in this way ought not to depend on the club being an unincorporated body. Indeed income tax law generally treats an unincorporated association in the same way as an incorporated body. This flows from the definition of “company” in s. 6 of the Assessment Act. If it is appropriate to look through the unincorporated body, it should be appropriate to look through the incorporated body. In fact, incorporation has not been treated as significant in relation to mutuality: Sydney Water Board Employee's Credit Union Ltd (1973) 129 C.L.R. 446 at 457 per Mason J.

Where the association is a members' club and the payment in question is made by a member for the purpose of meeting the cost of goods or services supplied by the club, any surplus of the payment being applied for the collective benefit of all members in the provision of the club facilities, the operation of Proposition 7 is less than clear. The difficulty arises in relation to the application of the surplus. The club's interest in the surplus may be clearly identified with the interests of the members from whom the payments are received, only if all members make like payments to the club. The club's interest is made up of the interests in the club of all members of the club. If only some members make payments for goods and services, the interests of those members cannot be identical with the interests of all members. The circumstances are like those involved in a distribution among all members of a surplus generated by the payments of some members, and these are circumstances where mutuality is not applicable. In fact disparities within a club, between those who finance facilities by their use of the club's dining room and bar and by their addiction to poker machines, and those who enjoy those facilities, are not taken to defeat the application of mutuality. Moreover the fact that the dining room and bar are subsidised from the surplus on poker machines, is not taken to defeat
mutuality. The subsidy might have been seen as a distribution among members who use the dining room and bar of the surplus provided by those members who play the poker machines.

2.51 Consideration of the operation of mutuality will be unnecessary where the circumstances do not, in any respect, give an income character to an item. In the illustrations offered so far the item might have the character of income as one of a series of periodical receipts, for example an annual subscription received by a club; a payment for services, for example, a member's loss on a poker machine transaction; or a business receipt, for example a payment for a meal in a club's dining room or a payment for goods supplied by a co-operative. The effect of mutuality is to deny an income quality to an item which would, in other respects, have that quality.

2.52 It is proposed now to consider the operation of the mutuality principle more closely in relation to:

(i) members' clubs;
(ii) co-operatives, including credit unions in a broad sense of that word;
(iii) so-called mutual insurance companies; and
(iv) home-unit companies and statutory corporations under strata title legislation.

In a number of instances the mutuality principle has been affected by specific provisions of the Assessment Act. These specific provisions are noted in appropriate contexts.

Members' clubs

2.53 A number of aspects have already been considered in the general discussion. Mutuality may be applicable to receipts from members by way of subscriptions, and payments for goods and services. A phrase used by Griffith C.J. in *The Bohemians' Club* (1918) 24 C.L.R. 334 at 337—“advances of capital for a common purpose”—explains mutuality, in relation to subscriptions, in terms of Proposition 7. Surpluses over the cost of goods and services supplied to members will, in general, admit of the same description.

2.54 The identification of the interests of the club with the interests of those from which receipts proceed is only appropriate where the latter are continuing members of the club. The identification in these circumstances requires a flexible principle because membership may fluctuate, but the mutuality principle is not flexible enough to extend to receipts from “temporary members”, whose membership may be limited to a single occasion. If it were to be extended to temporary members, the principle would be deprived of all substance. The notion of membership for the
purposes of any formulation of the mutuality principle is not a matter of form. It is a matter of being a contributor to a fund in which the contributor has rights to participate, whether in cash or in kind.

2.55 The mutuality principle operates in relation to receipts from members, even though there are also receipts from non-members. There may be problems as to how much of total receipts are from non-members: there is a question whether a receipt is from a member when a member pays with funds provided by his guest. The difficulty of distinguishing receipts from members and receipts from non-members gave rise to an exchange between judge and counsel in *National Association of Local Government Officers v. Watkins* (1934) 18 T.C. 499 at 507. The taxpayer club will carry the onus of showing that the Commissioner's figures are wrong: s. 190(b). The Commissioner may have made assumptions from the visitors' book and otherwise which the taxpayer may find it difficult to refute.

2.56 Where there are receipts from non-members, an apportionment of expenses is appropriate in determining the surplus of receipts from non-members which is taxable income of the club. An apportionment was made in *Carlisle & Silloth Golf Club v. Smith* [1913] 3 K.B. 75 and in *Adelaide Racing Club Inc.* (1964) 114 C.L.R. 517. The apportionment is authorised by s. 51(1)—the general deduction provision—considered in Chapter 9, where the operation of the words “to the extent to which” in the section is discussed.

2.57 The discussion has so far proceeded on the assumption that the club rules do not provide for the return of surplus to members whose payments have generated that surplus, nor for the payment of dividends to members. A rule providing for the return of surplus will need to ensure that the elements of identity and proportion in returns to members, considered below in relation to co-operatives, are satisfied. A rule providing for the payment of an ordinary dividend to members from the surplus will preclude the operation of mutuality.

There is no basis for identifying the club's interests with the interests of members from whom payments are received if the surplus generated by payments by some members may be distributed among all members. An ordinary dividend will be paid to all members, whether or not they are members from whom payments were received.

2.58 A club may change its rules so as to provide for a distribution among all members from a surplus generated by payments made by only some members. The rule will have the consequences described in the last paragraph in relation to new receipts by the club. There is however a question as to the effect of the change in the rules in relation to any surplus of old receipts available at the time of the change. The operation of the
mutuality principle would have been judged by reference to the rules of the club at the time of a receipt by the club. The consequences in relation to a dividend paid after the change in the rules from a surplus available before the change, is considered in [2.85] below, in dealing with co-operatives.

2.59 Where a club's rules provide for a distribution on winding up which will not involve a benefit to members—for example, by payment to a charity—the operation of mutuality is not affected. A provision for distribution among all those who are members at the time of winding up without regard to their contributions to that surplus would preclude the operation of mutuality.

2.60 The fact that a payment is made to a member of an amount which is unrelated to any contribution the member has made to the club, does not necessarily preclude the operation of mutuality. It may be an object of the club to encourage sport or learning by financial support to individual players or scholars of merit, and it may happen that a player or scholar who receives support is a member of the club. The payment is not made to the member as such. There may be more difficulty about the operation of mutuality where the eligibility for financial support depends on membership of the club.

2.61 In *Fletcher v. Income Tax Commissioner* [1972] A.C. 414 at 422 Lord Wilberforce, in giving the judgment of the Privy Council, observed that “many clubs collect subscriptions of different amounts according to the use expected to be made of facilities, or to age, or personal circumstances, and this is consistent with ‘mutuality’”. It is none the less essential that there is a “reasonable relationship . . . between what a member contributes and what . . . he may expect . . . to draw from the fund . . . ” (at 423). Where a cash distribution is contemplated by the articles, and participation in that cash distribution will not reflect the fact of a substantial difference between the amounts of the subscriptions paid by some members and those paid by others, mutuality is not applicable. It was the prospect of a cash distribution, albeit one unlikely to be made, that resulted in the denial of mutuality in *Fletcher*.

2.62 Paragraphs (g) and (h) of s. 23 of the Assessment Act are relevant to the operation of the principle of mutuality in relation to members' clubs. Their effect is to make the income of certain clubs, for example, a club established for the encouragement of an athletic game or athletic sport in which human beings are the sole participants, exempt from tax. The exemption may mask the operation of the principle of mutuality in a particular case. But a non-income quality in some circumstances is more favourable than a quality of income that is exempt. If a payment is made to a member by a club whose income is exempt, the payment may be a
dividend and income that is not exempt in the hands of the member. Section 44(1), by providing that a distribution out of profits is an income receipt, will bring about this result. To the extent that the denial of an income character is the denial of a profit character, the fact that mutuality applies to a club's receipts will exclude the operation of s. 44(1). The exemption of income of the club will, however, extend to receipts that are not protected by the mutuality principle and which would be income and subject to tax in the hands of the club if it did not enjoy the exemption. Section 23(g) will exempt, for example, receipts of a ski club from non-members and investment income of the club.

2.63 There are questions as to the circumstances in which a club will qualify for an exemption under s. 23(e) as “a religious, scientific, charitable, or public educational institution”; or under s. 23(g) (ii) as “a society, association or club established for musical purposes, or for the encouragement of music, art, science or literature”; or under s. 23(g) (iii) as “a society, association or club established for the encouragement or promotion of an athletic game or athletic sport in which human beings are the sole participants”; or under s. 23(h) as “a society or association not carried on for the purposes of profit or gain to the individual members thereof, established for the purpose of promoting the development of aviation or of the agricultural, pastoral, horticultural, viticultural, manufacturing or industrial resources of Australia”. One general question concerns how significant the activity which attracts an exemption must be among the total activities of the club. In “The Waratahs” Rugby Union Football Club (1979) 79 A.T.C. 4337 the club engaged in some activity that could attract an exemption under s. 23(g) (iii). At the same time it carried on an activity as a social club. Waddell J., in denying an exemption, held (at 4341) that “it must appear from the evidence that the main or real purpose for which [the club] was established during the tax years in question was for the encouragement or promotion of an athletic game or athletic sport . . . and that the purpose of a social club was not collateral to or independent of this purpose but merely concomitant and incidental to it”. The consequence may be that a club will be denied exemption unless the sole purpose of the club—other than a purpose “concomitant or incidental” to that sole purpose—is a purpose that would attract an exemption. It may be doubted whether the High Court in Royal Australasian College of Surgeons (1943) 68 C.L.R. 436, on which Waddell J. relied, intended such a consequence. In a reference to the fact that the College's “other objects [were] not collateral or independent but merely concomitant and incidental to the main object”, Rich J. (at 447) may not have intended to do more than emphasise that surgical science promotion
will be the main object if there is no other object that is collateral to or independent of that object.

2.64 A club may derive income in receipts from non-members. For example, in *R.A.C.V.* (1973) 73 A.T.C. 4153, receipts by the Royal Automobile Club included receipts from non-members that were income. These receipts were returns from investments, receipts by way of commissions from airlines and hotels in respect of bookings made through the club and by way of commissions from insurance brokers in respect of insurance arranged through the club. There were also receipts from members in respect of road services provided for members, and receipts from one class of members in respect of social amenities provided for those members. If a club makes a cash distribution to its members from the receipts from non-members, the distributions will be within s. 44(1), and income of the members. The distribution will be income even though it is made to members in proportion to the contributions members have made. It is not a return to members of a surplus of receipts subject to the mutuality principle. Section 44(1) will possibly make the whole of the receipts by members in such a distribution income of the members, even though the distribution is only in part from receipts by the club from non-members. There is a question whether like conclusions will follow if receipts from non-members are used to subsidise the services provided to members. There was an element of subsidy of this kind in the road services provided by the club in *R.A.C.V.* There seems no reason to treat a distribution in kind differently from a cash distribution, though one might expect that there will be income in the nature of a dividend received by the member only to the extent of the element of the subsidy. *R.A.C.V.* was not concerned with the tax consequences of a distribution for members of the club.

2.65 It was not suggested in *R.A.C.V.* that the contributions made by those members entitled to use road services were used to subsidise the social amenities that were available only to the class of members entitled to use those amenities. It is arguable that a subsidy of this kind to those using the amenities would exclude the application of the mutuality principle to the receipts from members entitled to use road services. The receipts from the members entitled to road services, when applied for the benefit of members entitled to use the amenities, are not in a relevant sense receipts from members.

2.66 Where the club subsidises the provision of services to its members out of receipts from non-members, the element in the expenses incurred in the provision of services reflecting the subsidy will not be deductible in determining the taxable income arising from the receipts from non-
members. To this extent there is an apparent disadvantage in a conclusion that the mutuality principle applies to the receipts by the club from its members. If none of the activities of the club attracted the mutuality principle it might be thought that the surplus of expenses over receipts in the provision of the services would go to lessen the taxable income in the receipts from non-members. But it is at least arguable that, in these circumstances, the subsidy gives rise to dividends received by members just as much as it does when mutuality applies to the receipts from members.

Co-operatives

2.67 The word co-operative, as used in the present context, is intended to cover an association which supplies goods, services or finance to its members for a price which is no more than an estimate of cost, the arrangement being that any surplus of the price over cost will at some time be returned to the member who paid the price. Some of these associations will be “co-operatives” as defined in ss 117 and 118 of the Assessment Act and these are identified as Assessment Act co-operatives.

2.68 Supply of finance will involve lending to members at interest, and the co-operative engaging in this activity is generally referred to as a credit union. Credit unions are the subject of a number of judicial decisions and a specific provision of the Assessment Act, and are specially considered under the next heading.

2.69 The mutuality principle in its application to co-operatives has its origins in a number of United Kingdom cases concerned with the insurance cover given by an association to its members. Though the principle has, by s. 121 of the Assessment Act, been displaced in part, perhaps wholly, in its application to co-operatives providing insurance cover, the United Kingdom cases remain an important source of elaboration of the mutuality principle.

2.70 The operation of the mutuality principle has been displaced in relation to Assessment Act co-operatives by s. 119 of the Act, though, as will be seen, there may still be some scope for its operation in that context.

2.71 The scope of the mutuality principle in its application to a co-operative, may have been qualified by a statement in the judgment of the Privy Council in 

_English and Scottish Joint Co-operative Wholesale Society Ltd v. Commissioner of Agricultural Income-Tax, Assam_ [1948] A.C. 405 at 417. The statement purports to exclude the mutuality principle where an association “grows produce on its own land or manufactures goods in its own factories . . . and sells its produce or goods to its members.
exclusively”. The possible qualification is the subject of later comment.

2.72 The mutuality principle in relation to co-operatives is a direct application of Proposition 7. There must be a receipt by the association of money which is to be used in serving the purposes of the person from whom the money is received, any surplus being held for return to that person. The requirement that any surplus must be held for return ensures that there is no benefit, and thus no gain, to the association. There is not even that appearance of benefit to the association which needs to be explained, where the association is a members' club, by identifying a benefit to the club with benefit to the individual member from whom money is received, an identification expressed in the phrase “a payment to oneself”. And the fact that the association is incorporated presents no conceptual difficulty. It has been held to be irrelevant in cases involving credit unions discussed under the next heading.

2.73 The concept of surplus held for return to individual members is to be distinguished from a concept of surplus held for distribution among members. Drawing this distinction has given rise to most of the cases on the application of mutuality to co-operatives.

2.74 There may not be much difficulty in drafting the rules of a mutual insurance association so as to attract mutuality, though s. 121 of the Assessment Act has taken most of the point from the exercise. On the other hand an ordinary provision for the payment of dividends from profits in the articles of a company engaged in the business of retailing is a provision for a distribution among members, and mutuality will not be attracted simply because some shareholders have shopped at the company's stores. It is between these poles that the difficulties are to be found.

2.75 A strict view of the mutuality principle would require that receipts should be regarded as subject to a return of surplus to the members from whom they were received, only when the returns must be to the identical members who contributed and in exact proportion to their contributions. Tests of exact identity and proportion were expressed in the earlier United Kingdom mutual insurance cases, but the tests were thereafter considerably relaxed.

2.76 Lord Macmillan in Municipal Mutual Insurance Ltd v. Hills (1932) 16 T.C. 430 appears to require precise identity and exact proportion. Other cases however suggest that something less, provided there is substantial identity and proportion, will be sufficient to justify the application of the mutuality principle. In Jones v. S.W. Lancashire Coal Owners' Association Ltd [1927] A.C. 827 at 832, Viscount Cave, L.C., in holding that the mutuality principle applied in the case before him, said: “Sooner or later, in meal or in malt, the whole of the company's receipts must go back to the
policy holders as a class, though not precisely in the proportions in which they have contributed to them.” In *Faulconbridge v. National Employers’ Mutual General Insurance Association Ltd* (1952) 33 T.C. 103 at 125, Upjohn J. said: “I think it is clear that when Lord Macmillan speaks of the cardinal requirement being complete identity between the contributors and the participators, he is not referring to individual identity but to identity as a class, so that at any given moment of time the persons who are contributing must be identical with the persons who are entitled to participate; whereas it follows, in my judgment, that it matters not that the class has been diminished by persons going out of the scheme or that others may come in in their place in the future.” These observations should be read in relation to the facts of the cases. In *S.W. Lancashire Coal Owners’ Association* the substantial factor in determining a member's entitlement to participate was the amount of his contribution, though this was qualified by other factors so that entitlement was not in exact proportion to contribution. In *National Employers’ Mutual General Insurance Association Ltd* the rules provided that, while the Association continued, a division of surplus might be made among members for the time being “in proportion to their surplus premiums”. On winding up, a division of surplus was to be made among members “in such proportions as shall be certified to be fair and equitable by an actuary”: (1952) 33 T.C. 103 at 115.

2.77 Most recently in *Fletcher v. Income Tax Commissioner* [1972] A.C. 414 at 423 the Privy Council said:

“It may not be an essential condition of mutuality that contributions to the fund and rights in it should be equal; but if mutuality is to have any meaning there must be a reasonable relationship, contemplated or in the result, between what a member contributes and what, with due allowance for interim benefits of enjoyment, he may expect or be entitled to draw from the fund: between his liabilities and his rights.”

2.78 The absence of a “reasonable relationship” between the contribution by a member and the amount of an actual or possible payment by the association to the member precluded mutuality in that case. This is also an explanation of the failure of the mutuality submission in *English & Scottish Joint Co-operative Wholesale Society Ltd v. Commissioner of Agricultural Income-Tax, Assam* [1948] A.C. 405. Under the rules of the association surplus might be applied in a number of ways inconsistent with mutuality, including the payment of interest on share capital and appropriation to a reserve whence, presumably, it might be the subject of a dividend, or held until liquidation and then distributed among members.

2.79 In *English and Scottish Joint Co-operative Wholesale Society* the
Privy Council said (at 420): “there is no common fund to which the members . . . contribute and in which they participate.” That observation would appear to be no more than a way of stating the absence of reasonable relationship between contribution to the association and receipt from the association. It will be seen under the next heading that the reference to a “common fund” has, in the Australian authorities in relation to credit unions, been erected into a distinct aspect of the mutuality doctrine.

2.80 In the course of argument in *English and Scottish Joint Co-operative Wholesale Society* it was submitted that where a payment was in fact made under a rule which provided that surplus might be applied in the making of payments to members rateably in proportion to the amount of purchases made by them from the association, this application of surplus might be treated as a discount having the effect of reducing the price of the goods sold to members. No opinion was expressed on the submission. Where goods are sold on terms that provide for the allowance of a discount for prompt payment, the application of the principle in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314, discussed in Chapter 11, will withhold a conclusion that the amount of the discount is income derived until it becomes clear that the discount will not be allowed. It may be doubted that this principle would apply where there is no obligation to allow the discount at the time of the sale. Where, however, the *Arthur Murray* principle does apply, its operation will be similar to the mutuality principle. It should be noted that there is no limitation on the operation of the *Arthur Murray* principle of the kind that has been erected in the Australian authorities around the words “common fund”. The limitation is discussed below in relation to credit unions.

2.81 Reference has already been made to a statement in *English and Scottish Joint Co-operative Wholesale Society* that would exclude the availability of the mutuality principle to producers of goods. The judgment does not, however, explain why mutuality is not available. If mutuality is not available to an association producing goods, it may be asked why it is available to an association that obtains and supplies goods to its members, obtains and supplies finance to its members, supplies management or investment services, or supplies sporting facilities. *Sydney Water Board Employees' Credit Union Ltd* (1973) 129 C.L.R. 446 is authority that mutuality is available to an association obtaining and supplying finance. *Fletcher v. Income Tax Commissioner* [1972] A.C. 414 is authority that mutuality is available to an association supplying sporting facilities. These cases indicate that the availability of mutuality does not depend on what is supplied to members, but on the manner of the transaction in which the
In *Fletcher* the question is posed (at 422): “At what point . . . does the relationship of mutuality end and that of trading begin?” Their Lordships accepted that mutuality is not necessarily excluded by the fact that some members are corporate bodies, or even corporate bodies engaged in trade. In this regard, they drew attention to the mutual insurance cases. The case itself concerned the application of the mutuality principle to receipts from “hotel members” of a club which provided swimming facilities for members and for guests of the “hotel members”. The Privy Council concluded that the club was trading with its hotel members because of the disparity between the interest of the hotel members in surplus and that of ordinary members. It observed (at 423): “The hotel members may be said, through the advantages gained for their guests, to derive current advantages commensurate with their subscriptions; but as regards any surplus, the disparity between their interest and that of ordinary members is one of substantial scale.” The implication of *Fletcher* is that there is no class of activity by an association which is inherently incapable of attracting the operation of the mutuality principle. Provided the tests of identity and proportion are satisfied in relation to any benefit to be given or payment to be made to members, the association will be held not to be trading with its members.

Where mutuality is applicable, receipts from members, and it follows, the surplus of such receipts, will not be income of the association. And, it is submitted, those receipts will not be “profits” of the association, so that a return to a member from them will not be income as a dividend out of profits under s. 44(1). Since the receipts are not income, a return to a member from them in the liquidation of the association will not “represent income”, and will therefore not be income as a deemed dividend under s. 47. A return to a member may, however, be income of a member engaged in business as a gain in carrying on the business: *H. R. Sinclair & Son Pty Ltd* (1966) 114 C.L.R. 537, considered in relation to Propositions 14 and 15, is relevant. Were it not for this prospect of the return being income, the operation of the mutuality principle would open up considerable scope for tax planning.

A member of an association who obtains goods or services from the association under transactions attracting mutuality, will, it seems, be entitled to deduct the amounts paid to the association if he obtains the goods or services in the carrying on of a business. Even though a return to him of some part of what he has paid is income on the authority of *Sinclair*, there may yet be a tax advantage, by way of deferral, if payment for the goods or services is made in a year earlier than the year in which supply is effected.
the amount returned is received. There will be tax accounting issues more closely considered in Part III of this Volume. It is enough for present purposes to say that a right to a return will not give rise to income derived until the amount to be returned is ascertained. The advantage of tax deferral is of the kind at which s. 82KK, considered in [11.289]ff. below, is directed. But that section will have no application where the person paying for goods or services does not, in any sense, control the association. In Chapter 11 there is a discussion of the possibility of a development in tax accounting which would involve a principle in relation to deductions parallel with Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314 in relation to receipts. Such a principle would preclude the tax deferral by denying a deduction of the payment to the association to the extent that there is a prospect of return of the amount paid, and while that prospect remains. Such a development would require a reconsideration of the Sinclair principle.

2.85 The rules of a co-operative may have been drafted, and its affairs conducted, in such a way as to attract mutuality. It may have accumulated a substantial surplus, which under the rules are to be returned to those from whom payments were received, perhaps on winding up. It may be asked what the tax consequences will be should the association now change its rules so that a distribution among members may be made. There would be company law issues raised, going to the validity of the change. But assuming the change is valid, there is a question whether the change has any effect on the operation of mutuality in the years before the change. Presumably the change could not retrospectively make receipts of earlier years income. Nor could it make those receipts profits so that a distribution from them would be income as a dividend under s. 44(1).

2.86 The operation of the mutuality principle is, at least in some respects, displaced by Div. 9 of Pt III, in relation to co-operatives as defined in ss 117 and 118—referred to in this Volume as Assessment Act co-operatives. To be within the definition, a co-operative must, by its rules, “limit the number of shares which may be held by, or by and on behalf of, any one shareholder, and prohibit the quotation of the shares for sale or purchase at any stock exchange or in any other public manner whatever”. It will be apparent that it is not difficult for an association to put itself out of the category of Assessment Act co-operatives, and take what tax advantage there may be in drafting its rules and conducting its affairs so as to attract mutuality.

2.87 To be within the definition of an Assessment Act co-operative in s. 117, a company must be one that in the year of income “is established for the purpose of carrying on any business having as its primary object or
objects one or more of [a number of listed objects]”. As the definition is interpreted by the High Court in *Brookton Co-operative Society Ltd* (1981) 147 C.L.R. 441, an initial question is raised as to whether the company can be said to be “established for the purpose of carrying on [a] business” (at 445). It will, in the year of income, be established for the purpose of carrying on a business if that purpose is dominant among the purposes of its total activities, which may include investment activities. There is then a further question whether the business has as its primary object one or more of the listed objects. Presumably two listed objects pursued by the company will be treated as one object when the question is whether those objects are primary. Whether an object is primary must be determined by reference to “the actual activities of the [company]”: *Revesby Credit Union Co-operative Ltd* (1965) 112 C.L.R. 564 at 576, per McTiernan J., approved by Gibbs J. in *Social Credit Savings & Loans Society Ltd* (1971) 125 C.L.R. 560 at 567. The reference in the words “is established for the purpose” in s. 117 is to the purpose for which the company's activities were carried on in the year of income.

2.88 The listed objects are:

“(a) the acquisition of commodities or animals for disposal or distribution among its shareholders;
(b) the acquisition of commodities or animals from its shareholders for disposal or distribution;
(c) the storage, marketing, packing or processing of commodities of its shareholders;
(d) the rendering of services to its shareholders;
(e) the obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business.”

The lending of money to shareholders is not the rendering of services to shareholders: *Revesby Credit*. A credit union cannot therefore qualify as an Assessment Act co-operative unless its business has another object that is the rendering of services and that object is primary.

2.89 The displacing of mutuality in relation to Assessment Act co-operatives is the general effect of s. 119 which provides:

“The assessable income of a co-operative company shall include all sums received by it, whether from shareholders or from other persons, for the storage, marketing, packing or processing of commodities, or for the rendering of services, or in payment for commodities or animals or land sold, whether on account of the company or on account of its shareholders.”

It will be noted that mutuality is not displaced by this provision in regard to receipts of interest from members by the Assessment Act co-operative. This matter is the
subject of comment under the next heading.

2.90 The consequences of the displacing of mutuality are to an extent offset by s. 120(1), which allows the Assessment Act co-operative a deduction of the amount of income distributed among members as rebates or bonuses based on business done by members with the co-operative, or distributed by the co-operative among its members as interest or dividends on shares. Probably, distributions as rebates or bonuses based on business done would be deductible without the aid of s. 120(1), though it is arguable that a rebate or bonus will not be deductible without the aid of s. 120(1) if it operates as a distribution of income derived from persons who are not members. The deduction of distributions as interest or dividends on shares would not otherwise be available.

2.91 The special treatment of Assessment Act co-operatives provided for in s. 120(1) was sought to be attracted by the planning in the *Brookton Co-operative Society Ltd* (1981) 147 C.L.R. 441. The company failed to qualify as an Assessment Act co-operative because it was held not to meet the conditions specified in the definition of an Assessment Act co-operative in s. 117. It was not “established for the purpose of carrying on any business having as its primary object or objects” one or more of those listed in the section. It could only be “established for [such a] purpose” if carrying on a business was the sole or dominant purpose in its current activities. The dominant purpose in its current activities, in the view of the High Court, was investment in companies through which dividend stripping arrangements would be carried out. The case is important not only for the interpretation of s. 117, but also because of the assumption, on which the case proceeds, that a rebate or bonus, based on business done by members with the co-operative, or interest or dividends on shares, is deductible in determining the taxable income of an Assessment Act co-operative, even though the rebate, interest or dividend is paid from profits which are derived from activities that are not within the purpose which gives the Assessment Act co-operative its status as such. Provided they are distributed, such profits are not taxed to the co-operative. And if they are paid out to a shareholder by way of rebate or bonus based on purchases made by the shareholder, he will generally not be taxed on them: s. 120(2). In the result, status as an Assessment Act co-operative will enable the co-operative to escape tax on profits that could not have attracted the protection of the mutuality principle. And it may enable a member to escape tax on a distribution from such profits.

2.92 Section 120(2) provides that the rebate or bonus to which s. 120(1) relates, and which is based on “purchases” made by a member, will not be income of the member receiving it, save where the price of the purchases
made by him is allowable to him as a deduction of any year, which, presumably, includes deduction by way of depreciation.

2.93 It is arguable that the exclusion from income of the rebate or bonus received by a member is, to a degree, unnecessary. Mutuality is displaced by s. 119 so as to make the receipts of the Assessment Act co-operative income, but mutuality, it would be said, may continue to operate to exclude the receipts from “profits”, so that payment from the receipts is not income as a dividend. The exclusion is, however, necessary if the circumstances would not attract mutuality in any event. In this respect, and in respect of the deduction available to the co-operative of distributions as interest or dividends on shares, Div. 9 confers privileged treatment on Assessment Act co-operatives.

2.94 The proviso to s. 120(2) has the effect of limiting the operation of the subsection. It does not, however, make a rebate or bonus income where the price of purchase is allowable as a deduction. *H. R. Sinclair & Son Pty Ltd* (1966) 114 C.L.R. 537 is authority that a rebate or bonus received in such circumstances will generally be income.

**Credit unions**

2.95 A credit union—an association providing finance to its members by way of loans—may be an Assessment Act co-operative: *Revesby Credit Union Co-operative Ltd* (1965) 112 C.L.R. 564. It may qualify under s. 117(1)(d) by reason of counselling services associated with lending to members. Lending is not itself an activity which may satisfy s. 117(1). Where the credit union is an Assessment Act co-operative, mutuality, if it is otherwise attracted, will not be displaced by s. 119. That section does not extend to interest receipts from members. The credit union, as an Assessment Act co-operative, will enjoy the privileged treatment conferred by the Act on co-operatives which is explained under the last heading, without paying the price of losing the possible application of mutuality to its interest receipts. The member will not, however, enjoy the privileged treatment conferred by s. 120(2). A rebate or bonus in respect of interest paid to the credit union will not be based on “purchases” from the credit union.

2.96 If the rules of a credit union, and the manner in which its affairs are conducted, attract mutuality in regard to its interest receipts from members, those receipts will not be income and there will be no room for the operation of s. 23G. This is so even though the credit union is within the definition in s. 23G(1), and it is an approved credit union, the Commissioner being satisfied of the matters in s. 23G(3). Section 23G(2)
exempts the interest income of an approved credit union derived from its members (other than interest derived from members who are companies), but the section does not make interest receipts income.

2.97 Section 23G was added to the Assessment Act following the decision in Sydney Water Board Employees' Credit Union (1973) 129 C.L.R. 446 that mutuality did not apply to the interest receipts of the Water Board Credit Union. The object of the section is to give relief where mutuality is not attracted. But attracting mutuality may still be more advantageous. Section 23G can apply only to some credit unions—those defined in s. 23G (1)—and its application depends on the exercise of a discretion by the Commissioner. Moreover, the section simply makes income exempt, with the prospect that, under s. 44(1), a payment by the association to a member from that income will be income of the member that is not exempt, as being a dividend out of profits.

2.98 A credit union cannot enjoy the exemption under s. 23G and have the privileges accorded to an Assessment Act co-operative. This is the effect of s. 117(2). The privilege of deducting distributions would have had limited, if any, value to the credit union, where the credit union's income is only interest income received from its members. But the privilege would have been valuable where the credit union has income received from persons other than its members, for example interest on surplus invested with an association of credit unions. A credit union that seeks status as an Assessment Act co-operative may avoid the barrier of s. 117(2) by incorporating under the Companies Act: a company incorporated under the Companies Act cannot be an approved credit union. In any case qualification as an Assessment Act co-operative may automatically exclude status as an approved credit union. It will qualify as an Assessment Act co-operative if it is established for the purpose of carrying on a business having as its primary object the rendering of services to its members: s. 117(1). It would be argued that it cannot then be an approved credit union which must have “as its principal object” or “[carry] on as its principal business the raising of money from its members and the making of loans out of those moneys to its members”: s. 23G(1)(b).

2.99 Sydney Water Board and two cases which preceded it, Revesby Credit Union Co-operative Ltd (1965) 112 C.L.R. 564 and Social Credit Savings & Loans Society Ltd (1971) 125 C.L.R. 560, are the leading Australian authorities on the principle of mutuality. They involve issues which are raised in seeking to apply mutuality to any co-operative. In Revesby Credit and in Social Credit the failure to attract mutuality is explained without difficulty. In Revesby Credit payments were made to all members from the surplus generated by the receipts from borrowing members. In Social
Credit there was a nearer approach to a “reasonable relationship” between contributions to, and receipts from, a fund. But mutuality was defeated by the circumstances that, under the rules, the surplus of contributions by borrowing members might be used to pay bonuses to officers and employees, and that a distribution of the surplus on winding up would be made to all members. Provision for a payment of bonuses to officers and employees from the fund may not always preclude mutuality. Clearly the use of the fund in the payment of expenses of administering the fund, including the wages of employees, will not preclude mutuality. Gibbs J. did not see the provision for payment of bonuses as equivalent to a provision for the payment of wages.

2.100 In the course of his judgment in Social Credit, Gibbs J. referred (at 574) to the Privy Council decision in English and Scottish Joint Co-operative Wholesale Society Ltd v. Commissioner of Agricultural Income-Tax, Assam [1948] A.C. 405, observing that the Privy Council thought that identity of contribution and participation were not satisfied “because there was no common fund to which members of the society contributed and in which they participated”. The language of “common fund” had been used in a number of cases prior to the Privy Council decision, including Municipal Mutual Insurance Ltd v. Hills (1932) 16 T.C. 430. But until Social Credit the existence of a common fund had been seen as no more than a way of expressing a conclusion that there was a reasonable relationship between contributions and rights to return of surplus. It will be seen that in Sydney Water Board a requirement of a “common fund”, in some equity or accounting sense, appears to have become an essential element in circumstances attracting mutuality.

2.101 Sydney Water Board is the most recent case. The principal judgment is that of Mason J., who gave a number of reasons against the application of mutuality. Some of these reasons are offered as distinguishing the case from some others in which mutuality had been held applicable, and may not be intended to establish principles. Thus, Mason J. said that the lending was under “individual contracts of loan”, and interest was paid by a borrowing member “in discharge of a legal obligation to pay it” (at 458). Contract and legal obligation would not in any case distinguish the facts of Sydney Water Board from the facts in New York Life Assurance Co. v. Styles (1889) 14 App. Cas. 381 where, as it was put by Lord Watson (at 394), the policy holder “pays according to an estimate of the amount which will be required for the common benefit; if his contribution proves to be insufficient he must make good the deficiency; if it exceeds what is ultimately found to be requisite, the excess is returned to him”. The distinction between the facts in Sydney Water Board and New York Life is
not in terms of contract and legal obligation, but in the nature of the obligation in the latter case which extended to making further contribution in the event of insufficiency. In *Sydney Water Board*, Barwick C.J. (at 451) gave significance to this aspect of *New York Life* when he said of the facts in *Sydney Water Board* that the payment of interest by the borrowing members “cannot be regarded in any sense as being a pro forma payment, the actual amount of the interest being determined by the experience of the taxpayer as the agent of the borrowing members in the provision and management of the money from which the lending was made”. In other cases, however, an obligation to make further contributions in the event of insufficiency has not been insisted on as essential to the operation of mutuality. If it is essential, most members' clubs will not attract mutuality.

2.102 A further ground of distinction from other cases emphasised by Mason J. is that the contributors in *Sydney Water Board* were only a portion of the total class of members (at 458). One would have thought that this is to give some ritual significance to the status of “member”. What is significant is a community of contributors and participators—of obligations and rights. It should be irrelevant that some “members” stand outside that relationship. They are simply not members in the relevant sense.

2.103 The two grounds essential to the decision in *Sydney Water Board Employees Credit Union Ltd* (1973) 129 C.L.R. 446 would appear to be the absence of a reasonable relationship between contributions by borrowers and receipts by borrowers, and, as a distinct ground, the absence of a “common fund”.

2.104 It is not easy to see why there was not a reasonable relationship. The rules of the credit union had been drafted to overcome the defects that led to a denial of mutuality in *Revesby Credit Union Co-operative Ltd* (1965) 112 C.L.R. 564 and *Social Credit Savings & Loans Society Ltd* (1971) 125 C.L.R. 560. There remained, however, elements of ambiguity. The provision that payments from the surplus of interest might, on winding up, only be made to “members to whom loans had been made”, left it uncertain whether the reference was to members who at any time had borrowed and as to the basis of the payments. The provision for payment of rebates of interest paid or due by borrowing members “based on business done”, in the view of Mason J., left some doubt as to the persons entitled to rebates and as to the basis on which they were entitled to receive them (at 453). One would have thought that, whatever construction was given to the rules, “reasonable relationship” was established. At least this was so if the relaxed tests of an adequate relationship in the United Kingdom cases remain part of the Australian law.
2.105 The ground that there was no “common fund” is also perplexing. One might have expected that the surpluses, current and accumulated, in the association's accounts were a sufficient common fund, since only borrowing members, under the rules, had any claim on those surpluses. There is no suggestion in other cases that some real fund, be it cash or a bank account, is intended when the word “fund” is used in describing the mutuality principle. Nor is it suggested that an accounting fund, subsisting only in books of account, is necessary, at least when only contributors are entitled to share in any surplus. The statement by Mason J. (at 458) that it is “artificial” to regard the interest paid by borrowing members as the common fund, is not in itself enlightening. More significant is the observation (at 457) that “the [mutuality] principle may be invoked by an association which engages in business activities with outsiders, in addition to the transactions which it has with its members, to the extent that it is possible to sever from the business activities the fund which consists of receipts from mutual dealings”. It is important to note that the association had income earning investments with outside bodies. Another significant observation (at 458) is that the rules “make it clear that the interest [paid by the borrowing members] forms part of the funds of the taxpayer and that the borrowing members are entitled to participate in a distribution of the surplus which results from the taxpayer's use of its general funds”. What emerges from these passages in the judgment of Mason J. is a conclusion that the association went too far in its attempt to overcome the defects in the rules of the associations in *Revesby Credit* and *Social Credit*, by confining any right to participate in surplus to borrowing members. The rules provided that the surplus of undoubted income receipts—returns from investment with outside bodies—could only be paid to borrowing members. And there was no distinction drawn in the accounts between payments from such surplus and payments from the surplus of interest from borrowing members. Any payment to borrowing members would include an element of distribution out of profits having an income quality as a dividend, and if mutuality had been held applicable the member would have had to rely on *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341, discussed in relation to Proposition 15, to justify a claim that the receipt by him was not income.

2.106 There is room left by *Sydney Water Board* for an argument that where there are receipts that, if they were the only receipts, would attract mutuality, mutuality may be attracted to them if, at least as a matter of accounting, they are kept distinct from receipts which are undoubted income. The argument may sit awkwardly with another observation of Mason J.—that the payments of interest made to lending members cannot
“with accuracy” be described as an outgoing in respect of a mutual liability of the borrowing members (at 459). If the receipts from borrowing members are segregated in the accounts, a charge in respect of interest paid to lenders which reflects the use of the money lent by lending members in making loans to borrowing members, does seem accurately described as an outgoing in respect of the liabilities of the borrowing members. It may be that Mason J. intended a reference to the possibility that the payment of interest to lending members is at a rate that is intended to effect a distribution to them of what would otherwise be a higher surplus from the receipts of interest from borrowing members. If it were evident that a credit union was paying rates of interest to lending members in excess of prevailing commercial rates, a finding that the interest is intended to effect a distribution might be appropriate and the finding would exclude the principle of mutuality.

2.107 If mutuality is not attracted in what is otherwise a Sydney Water Board situation if the receipts which claim mutuality are kept distinct from receipts which are undoubted income, the law in relation to credit unions is less than satisfactory. The exemption which is offered by s. 23G does not encourage a policy of lending to borrowing members at minimum cost, a policy which a credit union may fairly wish to follow. If s. 23G applies, any rebate to a member will be income as a dividend. The application of s. 23G precludes status for the credit union as an Assessment Act co-operative: it would, in any event, find it difficult to qualify for such status. Credit union borrowers are thus denied the privileged treatment for their receipts from the association which s. 120(2) gives to members of other Assessment Act co-operatives.

2.108 There may be some prospect of the law becoming satisfactory, if the discount approach already discussed in connection with English and Scottish Joint Co-operative Wholesale Society Ltd [1948] A.C. 405 is held to apply to a credit union. There will be a difficulty in the way, if the credit union is an Assessment Act co-operative: s. 119 could be construed to exclude the principle in Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314 on which the discount approach is based. But a credit union will not ordinarily be an Assessment Act co-operative.

Mutual insurance associations

2.109 By s. 121 of the Assessment Act, the assessable income of a company carrying on the business of insurance includes all premiums derived by the company, whether from its shareholders or not, other than premiums received in respect of policies of life assurance or considerations
received in respect of annuities granted. Life assurance companies are the subject of special provisions in Div. 8 of Pt III. Section 121 applies notwithstanding that the association is not incorporated: *Mildura & District Dried Fruit Growers' Hail Storm Damage Compensation Scheme* (1968) 118 C.L.R. 342.

**2.110** Section 121 precludes the application of the mutuality principle to the premiums received by a mutual insurance association. The principle is to this extent denied operation in an area to which it owes much of its development. But the premiums received are not by s. 121 made profits of the association, and it may be that the mutuality principle is still relevant in determining whether a distribution by a mutual insurance association is income of its members.

**Home unit corporations**

**2.111** The principle of mutuality may be important in determining whether levies made by a home unit company or a statutory company under the *Conveyancing (Strata Titles) Act* (N.S.W.) are income. Where the whole amount of the levies is expended in repairs to the building or in other outgoings which will be deductible if the levies are income, there will be no need to consider whether the levies are income. But it may be that some of the outgoings are of a capital nature or that the outgoings do not wholly consume the amount of the levies: the corporation may wish to make a provision for future expenses.

**2.112** The mutuality principle would appear to exclude the levies from income. Holding Proposition 7 applicable is no more difficult here than in the case of subscriptions received by a member's club. It will be important, however, in the case of a home unit company where the levies are to be used for purposes that relate to all units in the building, to ensure that levies are made on all shareholders, including the promoter if he still holds shares relating to units not yet sold.

**Proposition 7:** There is no gain if an item is derived by the taxpayer as a contribution to capital

**2.113** Proposition 7, like Propositions 5 and 6, reflects the principle, asserted in Proposition 4, that to have the character of income an item must be a gain by the taxpayer who derived it. Proposition 6, the mutuality principle, has been explained as a particular application of Proposition 7. It is an application of Proposition 7 in the context of payments received by an association from its members.
The central phrase in Proposition 7 is “contribution to capital”. A similar phrase will be found in mutuality cases, for example, *The Bohemians’ Club* (1918) 24 C.L.R. 334 at 337: “advances of capital for a common purpose.” A receipt by one person from another of money which must be applied in serving the purposes of the person paying, any surplus being returned to him, will generally not involve any gain by the receiver. The employee who receives an allowance for expenses incurred in carrying out his duties, and is required to vouch his expenses to his employer, does not derive income. The allowance is not in any part a gain to him. In other circumstances the applicability of the notion of contribution to capital may not be so clear. The illustration of a housewife who receives an allowance for housekeeping, referred to by Willmer L.J. in *B.B.C. v. Johns* [1965] Ch. 32 at 64 is not so clear, because there is some benefit to the housewife in the spending of the allowance. It may be argued that benefit to the housewife is not a purpose of the payment, so that the gain to her can be ignored just as we might ignore benefit to the employee who spends his allowance entertaining his employer's clients, and, incidentally, himself. But such an argument is not directed to bringing the circumstances within the contribution to capital principle. It is rather directed to a denial that the receipt by the housewife has the character of income under one of the Propositions 11–15, in particular to a denial that it is a reward for services.

It is the aspect of benefit to the receiver which creates the difficulty in regard to the application of Proposition 7, via a principle of mutuality, to a member's club. The difficulty, it will be recalled, is overcome by identifying benefit to the club with benefit to the member who pays to the club, an identification expressed in the phrase “a payment to oneself”. The use of the amount provided by the member is in the individual interest of the member as one of the community of members so long as no part of it is or may be paid out in a distribution among members. The club has no interest distinct from the individual interests of each of the members paying to the club. Where, however, there can be a distribution of surplus among members of the club, the club embodies interests of members which are not interests of individual members paying to the club. There is thus benefit to the club, and Proposition 7 is not applicable.

*B.B.C. v. Johns* is a decision that the British Broadcasting Corporation had no interest of its own to be served in the spending of the annual grant made to it by the United Kingdom Government. The B.B.C. was no more, in substance, than the agent of the Government in spending the grant, so as to provide broadcasting services to the public. The grant was not income of the Corporation, though amounts received as returns on investments made by the Corporation, and amounts received from the sale
of its publications, did involve income. Those who paid amounts that were investment income of the Corporation and those who paid for the Corporation's publications did not impose any obligation on the Corporation as to the use of the money they paid.

2.117 In another United Kingdom case, Hochstrasser v. Mayes [1960] A.C. 376, the absence of benefit and thus gain to the receiver is not as obvious. An employee received an amount, as a member of a scheme established by his employer, by way of compensation for the loss he suffered on the sale of his home when he sold the home in the course of moving to another town where his employer now required him to work. The House of Lords unanimously decided that the amount received was not income. The judgments give diverse grounds for the decision. Some of these grounds—that the employment was only the sine qua non of the payment of the amount, not the causa causans (at 388, per Viscount Simonds), that the payment was made to the employee “in respect of his personal situation as a house-owner, who had taken advantage of the housing scheme” (at 392, per Lord Radcliffe), and that the scheme “was introduced . . . as part of a general staff policy to secure a contented staff” (at 395, per Lord Cohen)—are not persuasive. They do not, in any event, involve the contribution to capital principle, but rather an assertion that the receipt was not a gain in carrying on an employment.

2.118 Another ground of decision is implicit in some observations in the judgments, and becomes explicit in the judgment of Lord Denning (at 396-7):

“My Lords, tried by the touchstone of common sense—which is, perhaps, rather a rash test to take in a revenue matter—I regard this as a plain case. No one coming fresh to it, untrammelled by cases, could regard this £350 as a profit from the employment. Mr Mayes did not make a profit on the resale of the house. He made a loss. And even if he had made a profit, it would not have been taxable. How, then, can his loss be taxable, simply because he has been indemnified against it? I can readily appreciate the case which was put in argument—namely, that if an employer, by way of reward for services, agrees to indemnify his employee against his losses on the Stock Exchange, the payments which the employee received under the indemnity would be taxable. But that would be because the losses were his own affair and nothing to do with his employment: the payments of indemnity would there be a straight reward for services. This payment of £350 was nothing of that kind. It was a loss which Mr Mayes incurred in consequence of his employment and his employers indemnified him against it. I cannot see that he gets any profit therefrom. If Mr Mayes had been injured at work and received money compensation for his injuries, no one would suggest that it was a profit from his employment. Nor so here, where all he receives is compensation for his loss.”

This ground of decision is the contribution to capital principle. The
employee received an amount which his employer had agreed to provide for the purpose of meeting a cost incurred by the employee in carrying out the duties of his employment. The receipt was not different from a reimbursement the employer might have paid under an agreement to meet outgoings incurred by the employee in carrying out the duties of his employment. There is no gain to the employee in such a receipt.

2.119 The passage quoted from the judgment of Lord Denning has, however, the seeds of confusion in the reference to the fact that a profit by the employee on the sale of the house would not have been taxable. The suggestion is that the loss in fact suffered was a capital loss, and that compensation which recoups a capital loss is not income. No such proposition can be maintained. A gain which is for an item that would have had the character of income, or for an item that has the character of a cost of deriving income, will be income under Proposition 15. But the converse is not so: it would not be correct to infer that a gain which is compensation for an item that would not have had the character of income, or for an item that does not have the character of a cost of deriving income, is not income. It is not income under Proposition 15, but it may yet be income as a reward for services under Proposition 13 or as a gain arising in carrying on a business under Proposition 14.

2.120 There is another way of identifying the seeds of confusion in the passage quoted. An item may be income under Proposition 13, as a gain arising from employment, even though it recoups a loss which is a cost of deriving employment income, whether or not the item is a capital loss in any sense of those words. In the circumstances of Hochstrasser v. Mayes [1960] A.C. 376 a cost of moving home is more likely to be regarded as a private cost and thus not a cost of deriving income. The taxpayer is thus not at risk that Proposition 15—the compensation principle—will hold the recoupment to be income. He is at risk that the compensation will be treated as income as a gain arising from his employment. The submission of this Volume is that this consequence should not follow. It should not follow because there is no gain and it is of no consequence that the item is one arising from his employment.

2.121 Where an employee incurs a loss or outgoing which is prima facie a cost of deriving his employment income, it will not matter, in practical consequences, that the recoupment by his employer is treated as income. None the less, the submission of this Volume is that where the contribution to capital principle is attracted, a recoupment is not income whether or not it is a recoupment of a cost that is prima facie deductible. If the recoupment is not income, there is no loss or outgoing whatever the prima facie view may be. There is no income because there is no gain. There is no loss or
outgoing because there is no cost.

2.122 The above analysis is at odds with a number of judicial decisions in United Kingdom and New Zealand concerned with payments received which are linked, in substance, with capital outgoings incurred by the taxpayer on improvements to business premises. Some, at least, reflect a growth from seeds of confusion of the kind in the passage quoted from the judgment of Lord Denning in *Hochstrasser v. Mayes*. Because money was received subject to an obligation to apply it in effecting improvements of a capital nature, or was received in respect of the cost of improvements of a capital nature already effected, it was not held to be income.

2.123 In some cases it would have been enough to say that the receipts did not have the character of income under any of the principles (Propositions 11–15 in this Volume), which may give the character of income to a receipt. However, at least some of these decisions involve a distortion of the contribution to capital principle. They take that principle out of its role as an expression of the fundamental requirement that income involves a gain. In some instances the improvements did not involve any increase in the value of the premises of the taxpayer—they simply adapted the premises to their role as a place of selling the products of the person making the payments. Where payments were received subject to an obligation to use them in making these improvements, the contribution to capital principle as understood in this Volume was attracted. But where the payments were made, without prior agreement, to recoup the costs already incurred of adapting the premises, the contribution to capital principle, as understood in this Volume was not attracted.

2.124 An even more distorted version of the contribution to capital principle was adopted in those cases where the improvements did involve an increase in the value of the taxpayer's premises.

2.125 The United Kingdom judicial decisions are *Seaham Harbour Dock Co. v. Crook* (1931) 16 T.C. 333; *Boyce v. Whitwick Colliery Co. Ltd* (1934) 18 T.C. 655; *I.R.C. v. Coia* (1959) 38 T.C. 334; *McLaren v. Needham* (1960) 39 T.C. 37; *Walter W. Saunders Ltd v. Dixon* (1962) 40 T.C. 329. The New Zealand decision is *C.I.R. v. City Motor Service Ltd & Napier Motors Ltd* [1969] N.Z.L.R. 1010. In their formulation of the contribution to capital principle, these decisions lead to a quite unacceptable extreme, under which a receipt for services rendered by a taxpayer will not be income if, under the contract of service or by some statement of the employer, the receipt is to be used to effect extensions to the taxpayer's home, or is received by way of recoupment of the costs of extensions already made. It is true that in all the cases referred to, the person paying had an interest in—a benefit derived from—the
improvements effected. But this purpose will not preclude an income receipt by the taxpayer receiving the payment, under the contribution to capital principle, if there is a gain to that taxpayer. Where the receipt is subject to a condition that the improvements will be made, there is a gain only to the extent that the improvements increase the value of the taxpayer's property. Any deduction otherwise available to him, currently or by way of depreciation in respect of the improvements, will be diminished by the amount of the receipt. So far as the receipt involves a gain, it will be income. Where the receipt is not subject to a condition, the actual use by the taxpayer in effecting improvements will be irrelevant and the whole receipt will be income, if it has in other respects an income character. The same consequence will follow if the payment is made for the purpose of recouping costs already incurred by the taxpayer without any prior arrangement for recoupment.

2.126 The fact that the person making a payment has an interest in the application of the money paid is relevant to the question whether the payment is a reward for services of the taxpayer who receives it, or is a gain arising from the carrying on of a business by the receiver. But the purpose of the person making the payment does not displace the operation of principles by which rewards for services and gains from carrying on a business are income.

2.127 There are several United Kingdom cases concerned with contributions, from public funds, received by a taxpayer engaged in business. Where the contribution is “assistance . . . given for the purpose of being used in the business . . . so as to enable him to meet [his] trading obligations”, the contribution to capital principle will have no application (Pontypridd and Rhondda Joint Water Board v. Ostime [1946] A.C. 477 at 492, per Lord Thankerton). But Lincolnshire Sugar Co. Ltd v. Smart [1937] A.C. 697, Higgs v. Wrightson [1944] 1 All E.R. 488 and White v. Davies [1979] 1 W.L.R. 908 suggest that the contribution to capital principle will apply so as to exclude the contribution from income where: (i) the contribution is in the nature of a loan or (ii) it is intended to recoup “a capital depreciation” (Higgs v. Wrightson [1944] 1 All E.R. 488 at 489 per Macnaghten J.) rather than “to be used [by the company] in [its] business” (Lincolnshire Sugar Co. [1937] A.C. 697 at 704, per Lord Macmillan).

2.128 In Higgs v. Wrightson the taxpayer was assessed on a wartime “ploughing grant” which he had received in connection with the ploughing of his pasture land to prepare it for intensive cultivation. His counsel argued that the intention of the legislation which provided for the payment was to compensate the taxpayer for the capital depreciation of the land
which resulted from the detrimental effects of ploughing. The suggestion by Macnaghten J. in *Higgs v. Wrightson* [1944] 1 All E.R. 488 that a payment to recoup a “capital depreciation”, is within the contribution to capital principle and the assumption in *White v. Davies* [1979] 1 W.L.R. 908 that a receipt to recoup a capital loss is within the contribution to capital principle, have the same seeds of confusion as appear in the judgment of Lord Denning in *Hochstrasser v. Mayes* [1960] A.C. 376. The contribution to capital principle will only be attracted if the capital depreciation or capital loss was incurred in giving effect to the interests of the Government agency from which the recoupment is received. And the capital depreciation or capital loss must involve no benefit to the taxpayer, such that he might have elected to experience the depreciation or loss had he not had the expectation of the recoupment. The argument by the taxpayer in *Higgs v. Wrightson* was rejected as not supported by the intention of the legislation or by the facts. However, had the intention of the Act and the facts been as counsel argued, the case would have been analogous to *Hochstrasser v. Mayes*. In *White v. Davies* an argument that the receipt was to meet a capital loss in the conversion of a herd of cattle from dairy cattle to beef cattle required by E.E.C. policy was rejected. If it had been accepted, this case too would have been analogous to *Hochstrasser v. Mayes*. The view taken was that the receipt was to compensate the taxpayer for income lost during the conversion.

2.129 The phrase “contribution to capital” is used as a description of a payment to a company in pursuance of a subscription for shares or debentures, or to meet calls in respect of shares or debentures. A receipt by a company in these circumstances would not have an income character under any of Propositions 11-15. It is, none the less, appropriate to note that, so far as the amount received is repayable by the company, it is within the contribution to capital principle.

2.130 The contribution to capital principle will explain why the receipts by the trustee of a superannuation fund, which may be taxed under Div. 9B of Pt III of the Assessment Act, do not include contributions to that fund by a member or by the employer of a member.

2.131 Section 26(g) is an express provision by which “any bounty or subsidy received in or in relation to the carrying on of a business (other than subsidy received under an agreement entered into under an Act relating to the search for petroleum)” is income. Section 26(g) is the subject of observations in the High Court in *Dixon* (1952) 86 C.L.R. 540, *The Squatting Investment Co. Ltd* (1953) 86 C.L.R. 570 and *Brisbane Amateur Turf Club* (1968) 118 C.L.R. 300. These observations are to the effect that the provision is inserted “simply for greater certainty” (*Dixon*, at
555 per Dixon C.J. and Williams J.), and does not modify or extend the meaning of income that is imported from ordinary usage. On this view, the contribution to capital principle, in its relevance to receipts that are described in the provision, is unaffected.

**Proposition 8: A gain which is a mere gift does not have the character of income**

2.132 This proposition, and Propositions 9 and 10, provide the focus of a preliminary survey of the scope of Propositions 11-15. The latter group might be called the positive propositions which describe the items which, being gains derived, have the character of income. Propositions 8, 9 and 10 are negative propositions which are helpful in setting some of the limits of the positive propositions. They are general negatives, as distinct from particular negatives. Some particular negatives are examined in stating the scope of each of the positive propositions. Thus, a statement of the scope of Proposition 12 is assisted by a negative proposition that an item is not a gain derived from property if it involves the realisation of the property itself. Propositions 8, 9 and 10 are helpful as the focus of a preliminary survey. In addition, they, or similar propositions, are asserted in the authorities and this in itself is sufficient reason to examine them.

2.133 Proposition 8 raises the question of how far the fact that a receipt is not one the taxpayer could have claimed as of right will take it out of a positive proposition otherwise applicable. In the discussion of policy issues at the beginning of this chapter, gifts received were identified as a class of accretions to economic power which are not within the base of the income tax, though the economists who are committed to the Simons goal of a comprehensive base would say that they should be. Given that the income tax base is not comprehensive, the task of legal analysis is to distinguish income from gifts received. Until recently gifts were the base of another tax—the federal gift duty—and too wide a definition of income raised the prospect of two taxes operating on the same receipt. There were problems of correlation, as in *Scott* (1966) 117 C.L.R. 514, a case considered in [2.135]ff. below.

2.134 The line of distinction between income and gift received has not been set, as it might have been, by excluding from income any receipt which the taxpayer could not have claimed as of right. Some gifts, in the sense of payments made voluntarily, are income, and Proposition 8 asserts only that “mere” gifts are not income. The word “mere” is used in this way in the authorities. The question is always whether the item is embraced by one of the positive propositions.
Product of services, employment or business

2.135 When the question is whether a gift—now used in this discussion in the sense of a payment made voluntarily—is income of the receiver under Propositions 13 or 14, as a reward for services or as a gain which arises from the carrying on of a business, the verbal issue is whether it is a “product” of the services, employment or business. The notion of product may be illustrated; it cannot be defined.


2.137 Once a connection is shown between the receipt and services, employment or business, it may not be easy to establish that the receipt was not a product. None the less an employer can make a gift to his employee which will not be income of the employee. In *Hayes* and *Harris* a gift by an employer to a former employee was held not to be income. And a business association between two persons does not mean that any gift made by one to the other must be that other's income. Whether a receipt is a product of an income-earning activity, in the view of Fullagar J. in *Hayes*, is to be answered by an objective assessment, although—and it may be thought there is some contradiction here—the motive of the donor is relevant, though “seldom decisive”. So too the donee's expectation of the receipt is relevant: *Squatting Investment*. The receipt will not be a product if it appears that the donor acted with regard only to the “personal qualities” of the donee (*Squatting Investment* and *Scott*). There is in this connection a distinction between a gift which is a reward for services and a gift made to a taxpayer as an expression of goodwill towards him personally, the goodwill having been generated by past services: *Walker v. Carnaby Harrower, Barham & Pykett* [1970] 1 W.L.R. 276.

2.138 Presumably, the dominant characterisation of the gift will prevail: there is no scope for an apportionment by which only a part of a gift is to be regarded as a product of the income-earning activity. To this extent the principle in *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341, discussed in [2.558]ff. below does not operate. That principle will deny an income character to the whole of a receipt where it relates in part only to an item of an income character and where no dissection or apportionment of the receipt is possible. There is thus a distinction to be drawn between a receipt that relates to two distinct items of claim, one only of which has an income character, to which *McLaurin* and *Allsop* are applicable, and a receipt that does not relate to any claim but might be thought to include in part an item of an income character, to which
McLaurin and Allsop are not applicable. In the latter instance the whole will take its character from the part, if the part is dominant. Where a receipt is in part in satisfaction of a claim to an item of an income character, for example wages due but not yet received, and in part the receipt of a gift that is not a product of a process of income derivation, for example a bonus added by the employer as an expression of goodwill, the law is undetermined. Possibly McLaurin and Allsop apply, though, in the example given, one might expect that a dissection or apportionment will be made.

2.139 Scott suggests that a legacy left, for example, by an employer to his former employee, will not be income. It may be asked whether the manner of the gift will always require that it be looked at as predominantly in recognition of the personal qualities of the donee. The magnitude of a gift inter vivos, for example the gift in Scott, may require that it be regarded as predominantly in recognition of personal qualities.

2.140 A gift may be income to the taxpayer as a reward for his services, notwithstanding that the donor is not the person for whom the donee was contractually bound to perform the services: Hayes per Kitto J. and Dixon. An employee who receives tips or inducements in the course of his employment may thus derive income.

2.141 The decision on the question whether a gift received is a product, may appear to turn on the weighing of objective and subjective factors, some supporting a conclusion that the gift is a product, some opposed. In Squatting Investment a conclusion that the receipt was one “resulting from the operation of wool growing”, (at 432) being a “voluntary addition to . . . the purchase price” of the wool (at 431), was indicated by the fact that receipts by suppliers of wool were in proportion to the supplies, and by the expectation of the taxpayer that he would, after the war, receive an addition to the price at which he had sold the wool. Against these factors it was impossible to set any suggestion that the payment was made to the taxpayer, a company, because of any personal qualities of the taxpayer.

2.142 In Hayes the shares received were held not to be a product. It was suggested that the shares were the product of the taxpayer's services given to the donor personally, or that they were the product of his employment by the donor's companies. Objective factors were against a conclusion that the shares were a product of any services or employment. The donor made gifts to others at the time of his gift to the taxpayer, and those other gifts were clearly not income of the donees. There was no expectation by the taxpayer of the receipt, and this also was against the conclusion. Clearly there was goodwill on the part of the donor generated by past services, but the goodwill of the donor is a factor that tells against a conclusion that the
receipt is a product of services, even though it has been generated by past services rendered.

2.143 In Scott, where again the conclusion favoured the taxpayer, the factors in the balance were more numerous, and perhaps more subtle, but the process of decision is the same. The objective factors supporting the taxpayer included the size of the gift, the gifts made to others, the place where the gift was made, and the fact that he had been paid for the professional work he had done. Against these objective factors might have been weighed the fact that the taxpayer, who was a solicitor, had not counselled the donor to seek independent advice, but Windeyer J. did not consider that any inference from this fact could be drawn. The taxpayer had no expectation of the receipt. Again there was undoubted goodwill on the part of the donor.

2.144 In Dixon (1952) 86 C.L.R. 540 the High Court rejected an argument that the addition to the taxpayer's military pay provided by his former employer was a product of his former employment. The fact that the addition made up his receipts to the amount of his salary in his former employment, might be thought an objective factor pointing to product of that employment. But the suggestion made is that a further reward for the services already performed would have been in a lump sum and not received periodically. There was anticipation of the receipts, but not at the time the services under the former employment were performed. The donor's actions suggested a motive of patriotism, not a motive to reward, at least not to reward services to the donor.

2.145 Dixon C.J. and Williams J. in Dixon considered the possibility that the made-up pay was a reward for military service. There was an element of expectation by the taxpayer, and the motive of the former employer could be regarded as a motive to reward him for his military service. The joint judgment is, however, equivocal. It runs together the possible operations of Proposition 11 and Proposition 13. Dixon C.J. and Williams J. said (at 557):

“"In the present case the employment or service, as we would emphasise, is as a soldier. The circumstances in which the taxpayer entered into that service were such as to enable him to rely with more or less confidence on the periodical payments from Macdonald, Hamilton & Co., as well as from his military pay, making up an 'income' of the level appropriate to civilian service. . . . Because the £104 was an expected periodical payment arising out of circumstances which attended the war service undertaken by the taxpayer and because it formed part of the receipts upon which he depended for the regular expenditure upon himself and his dependants and was paid to him for that purpose, it appears to us to have the character of income, and therefore to form part of the gross income within the meaning of s. 25 of the Income Tax Assessment Act 1936–1943."
Fullagar J. was unequivocal on the question of product: “The payment does not partake in any degree of the character of a reward for services rendered or to be rendered” (at 564).

2.146 The most recent Australian decision is *Harris* (1980) 80 A.T.C. 4238, involving a payment made by a bank to its retired employee. The majority in the Federal Court (Bowen C.J. and Fisher J.) thought the balance of factors was against product. There was no expectation by the taxpayer of the receipt: he did not know that amounts had been paid to other employees in the previous year. The amount he received had not been calculated with reference to the quality or length of his past services to the bank. The motive of the bank was not to reward the taxpayer for past services, but to be paternalistic—to assist the taxpayer because of the effects of inflation. The case concerned the first of several payments. Later year payments had been made to the taxpayer before the case came to court. The fact of later payments showed the likelihood that the payment in question would be repeated, but the significance of this in relation to a conclusion on the question of product is not apparent.

2.147 The judgment of Deane J. (dissenting) in *Harris* runs together the product issue and the question whether the receipt was income as one of a series of periodical receipts. Indeed his judgment runs together those questions, and the question whether the receipt was income as a compensation receipt (Proposition 15). Thus, a question is raised that is possibly already raised by the judgment of Dixon C.J. and Williams J. in *Dixon*, namely, whether it is proper to add together partial satisfactions of a number of principles to reach a conclusion that an item is income. Deane J. adverted to the factors thought significant by Bowen C.J. and Fisher J. on the question of product, and generally admitted their force. He then listed considerations which he thought required a conclusion that the item was income, only one of these considerations being relevant to the question of product. The relevant consideration was that the item “was received by the taxpayer because he was one of a class of ex-employees of the bank whose well being the bank was, for proper commercial reasons, concerned to protect” (at 4245).

**Periodical receipts**

2.148 *Dixon* and *Harris* assume, if they do not decide, that a gift may be income as a periodical receipt (Proposition 11). In this respect, Australian law differs from the United Kingdom law, as it appears in *Stedeford v. Beloe* [1932] A.C. 388.

2.149 The passage quoted above from the judgment of Dixon C.J. and Williams J. in *Dixon* may justify a conclusion that a receipt which is one of
expected periodical payments which form part of the receipts upon which
the taxpayer depends for the regular expenditure upon himself and his
dependants, and which are paid to him for that purpose, is income. The
passage quoted does, however, include a reference to the factor that the
receipt arose out of circumstances which attended the taxpayer's war
service. In this respect the conclusion may depend on the presence of a
factor which, though not enough in itself to attract the operation of the
product principle, will overcome the insufficiency of factors in relation to
the periodical receipts principle, and thus establish an income character for
the receipt. But, if this is the correct analysis, we are left uninstructed on
what the insufficiency was. And we are left perplexed, as we are by the
judgment of Deane J. in *Harris*, as to whether it is proper to add factors
which are insufficient to direct an income character on any one principle,
so as to reach a combination of factors which are sufficient to direct an
income character on some kind of amalgam of principles.

2.150 This aspect of the joint judgment in *Dixon* is not examined by
Bowen C.J. or Fisher J. in *Harris* (1980) 80 A.T.C. 4238. Bowen C.J. was
content to assert (at 4242) that (i) the receipt “was not periodical within
the income year” and (ii) it did not “form part of the receipts upon which he
depended for regular expenditure upon himself and his dependants”. He
had, earlier in his judgment, adverted to the fact that the taxpayer, though
retired from the bank, was still working as an accountant and was not in
need of the amount he received from the bank. He had also observed (at
4241) that where dependence on a receipt for regular expenditure is a
factor pointing to an income character, the law “place[s] the poor man at an
unnecessary disadvantage”. We are left to ponder the situation of an
impecunious student son receiving an allowance paid voluntarily by his
father.

2.151 Deane J. (dissenting) in *Harris* listed the factor that “the payment
was related to an annual period and was part of one group of a series of
annual groups of payments” as one factor which, with other factors
relevant to other principles, required a conclusion that the receipt had an
income character (at 4245). A comment on the amalgam of principles
approach has already been made.

2.152 Fisher J. thought the evidence of payments in subsequent years could
only be used to confirm any indication given at the time of the first receipt
that the taxpayer could expect to receive payments in the future. At the
time of the first receipt, there was no indication given that the taxpayer
could anticipate receipt of a like payment each year thereafter. In the result,
the first receipt could not be seen as one of a series of receipts that might
be within the periodical receipts principle.
2.153 *Harris* is authority that the first of a series of receipts, received at a time when the taxpayer had no anticipation of the first receipt and of subsequent receipts, cannot be income as one of a series of receipts that are within the periodical receipts principle. Where the taxpayer has come to anticipate further receipts, a receipt may be income within the periodical receipts principle. The principle was applied in such circumstances by Carter J. in *Blake* (1984) 84 A.T.C. 4661. In the view of Carter J., a broad judgment must be made of all the circumstances. Among those are the periodicity of the receipts that are anticipated by the taxpayer and the taxpayer's reliance on those receipts for regular expenditure on himself and his dependants. Save in the reference to the relevance of such reliance, he did not attempt any contribution to a statement of the substance of the periodicity principle.

**Compensation receipts**

2.154 The judgment of Fullagar J. in *Dixon* (1952) 86 C.L.R. 540 is authority that the compensation principle (Proposition 15) may apply to a voluntary receipt. He said (at 567-8):

“It seems to me that the appellant's receipts from Macdonald, Hamilton & Co. must be regarded as having the character of income. They were regular periodical payments—a matter which has been regarded in the cases as having some importance in determining whether particular receipts possess the character of income or capital in the hands of the recipient, see e.g. *Seymour v. Reed* [1927] A.C. 554, at 570 and *Atkinson v. F.C.T.* (1951) 84 C.L.R. 298. This consideration, while not unimportant, is not decisive. What is, to my mind, decisive is that the expressed object and the actual effect of the payments made was to make an addition to the earnings, the undoubted income, of the respondent. What the employing firm decided to do, and what it really did, in relation to the respondent and others in the same position, was ‘to make up the difference between their present rate of wages and the amount they will receive’. What is paid is not salary or remuneration, and it is not paid in respect of or in relation to any employment of the recipient. But it is intended to be, and is in fact, a substitute for—the equivalent *pro tanto* of—the salary or wages which would have been earned and paid if the enlistment had not taken place. As such, it must be income, even though it is paid voluntarily and there is not even a moral obligation to continue making the payments. It acquires the character of that for which it is substituted and that to which it is added. Perhaps the nearest parallel among the many cases cited to us is to be found in *Commissioner of Taxes (Vic.) v. Phillips* (1936) 55 C.L.R. 144.”

2.155 The passage quoted from the judgment of Fullagar J. contains two bases of decision. The first is a principle that a receipt that in its object and effect is to make an addition to the undoubted income of the taxpayer is income. It is income though it is the receipt of a voluntary payment and it
is not one of a series. Bowen C.J. in *Harris* (1980) 80 A.T.C. 4238 at 4243 rejected a principle thus stated. He concluded that the circumstances of the case before him were “insufficient” to justify a conclusion that the receipt was income “because the bank as payer intended it to be, and it in fact was, a supplement to the taxpayer's pension”. The further circumstances he thought necessary included an assurance, of which the taxpayer was aware—presumably at the moment of receipt—that the payment would be regularly forthcoming. Fisher J. agreed that there was no such assurance. Both judges, in effect, added an element to the principle stated by Fullagar J. The principle as it appears in the judgment of Fullagar J. has now been made a specific provision of the Assessment Act. Section 27H(1)(b) provides that “the assessable income of a taxpayer of a year of income shall include—the amount of any payment made to the taxpayer during the year of income as a supplement to an annuity, whether the payment is made voluntarily, by agreement or by compulsion of law and whether or not the payment is one of a series of recurrent payments”.

2.156 The other basis of decision to be found in the passage quoted from the judgment of Fullagar J. is a principle that a payment “intended to be, and [which] is in fact, a substitute for—the equivalent *pro tanto* of—” income that would have been derived if some event had not occurred, is income. This principle is identifiable as a compensation receipts principle. In the facts before him, the income that would have been derived was the salary and wages the taxpayer would have earned had he not enlisted in the Army. The principle as stated did not require that the payment should have been one of a number of regular periodical payments but the opening words of the passage quoted at least recognise the relevance of periodicity. Bowen C.J. and Fisher J. in their insistence on periodicity must be taken to have added an element to the principle as stated by Fullagar J. Precisely what element of periodicity they would require, does not appear. Nor does it appear whether this element of periodicity is distinguishable from the element of periodicity that will attract the operation of the periodical receipts principle. Indeed neither Bowen C.J. nor Fisher J. clearly distinguishes the compensation receipts principle from the periodical receipts principle.

**A gain derived from property**

2.157 A gift received may be income as a gain derived from property (Proposition 12). The connection of the gift with the letting of property, the licensing of technology or the lending of money, may be enough to deprive a gift received of a claim to be “mere”, and give it the character of income.
The United Kingdom decision in *I.R.C. v. Falkirk Ice Rink Ltd* (1975) 51 T.C. 42 suggests an illustration. A gift was made by members of a club enjoying facilities for the sport of curling provided by the taxpayer. The purpose of the gift was that the taxpayer might continue to provide facilities and improve the standard of those facilities, but there was no obligation imposed on the taxpayer. The gift was held to be income as a product of the carrying on of a business. Where there is no business, a like conclusion may be drawn. A landlord who receives a gift which is intended to persuade him to effect repairs to premises occupied by the donor, may derive income as a gain derived from property.

**Proposition 9: A mere windfall gain does not have the character of income**

2.158 This is the second of the general negative propositions. The word “mere” has been adopted from Proposition 8 in relation to gifts. The word “windfall” is intended to refer to receipts which are lottery or other prizes, and gambling winnings. A windfall gain will be income if it is sufficiently connected with services or a business or employment to be a product of the services, business or employment (Propositions 13 and 14), and it will be income if it can be regarded as derived from property (Proposition 12). It is hard to imagine facts which would make a windfall gain income as a periodical receipt (Proposition 11), or a compensation receipt (Proposition 15), but the possibilities exist in theory.

2.159 The fact that mere windfall gains are not income is another difference between the base of the income tax and the comprehensive, base which some economists would favour. Windfall gains may, indirectly, have borne another kind of tax. State taxes in relation to prizes and gambling are an important source of State revenue. The surpluses on State lotteries and Lotto are in effect taxes, and racing and poker machine operations attract a variety of taxes. The tax, in each case, is not directly on the prize or winnings, but it will have limited the amount available for the prize or the winnings.

**Prizes**

2.160 A lottery ticket given by an employer to his employee may be income as a product of employment. So too a ticket received as a reward for services, or received in the carrying on of a business, may be income as a product of the services or of the business. But a prize won by the ticket, like the shares obtained by the exercise of the option rights in *Abbott v.*
Philbin [1961] A.C. 352, would be seen as the proceeds of realisation of this right. It might be income on some principle other than the gain from employment principle, but the possibility is remote. The possibility that there might be income by ordinary usage as the profit from a business deal, or under the second limb of s. 25A(1) may be taken to have been rejected in Clowes (1954) 91 C.L.R. 209.

2.161 Other prizes may be products of services, employment or business. The question will be whether competing for the prize is an aspect of the performance of the services, or of the carrying on of the business. It will be an aspect, and the prize income, if competing is the activity which the taxpayer is employed to perform, or if competing is the service which is rewarded by the prize, or if competing is the activity which is the business or profession of the taxpayer. A taxpayer who is asked to take part in a television programme involving the winning of prizes may be seen as performing a service for which the prize is a reward. A professional tennis player or racing car driver may be seen as engaged in a business of competing for prizes. Racing horses may amount to a business and the prizes won will be income, though the Commissioner has not been over ready to assert that racing horses is a business nor have the courts been over ready to find that it is a business. The same comments might be made in relation to motor-racing. A cynic might suggest that the odds are against horse racing or motor racing being profitable, and the Commissioner stands on balance to be allowing losses rather than taxing winnings if the racing is recognised as a business. There is however a distinction to be drawn between hobby activity and business activity which does have some substance. The distinction is considered in relation to Proposition 14.

2.162 Competing for a prize may be an aspect of an employment or business, and the prize income, if it is incidental to the employment or business activity: Cooke and Sherden (1980) 80 A.T.C. 4140. An employer may have instituted an incentive scheme involving a competition for prizes among his employees. Entering for the prize is incidental to the employment. A professional golfer may devote most of his time to teaching and selling equipment. His occasional entry for a tournament may none the less be regarded as incidental to his business activity, and any prize he wins will be income. A cricketer or footballer may be employed to play cricket or football, or be engaged in a business of playing. Competing for a prize offered by some sponsor is incidental to the employment or business, and the prize is income. A motor car manufacturer may enter cars of its manufacture in a race or rally. Competing is incidental to the carrying on of its business, and any prize is income.

2.163 A prize may be income derived from property. In the United
Kingdom holders of “premium bonds” have chances to win prizes in a lottery conducted by the Government. It is at least arguable that a prize is income of a bond-holder as a gain derived from the investment in the bond. The reply may be open that the chance to win a prize is income, but the realisation of that chance does not give rise to another derivation of income. The reply would follow the analysis suggested above in relation to a lottery prize won by an employee who received the ticket as a gain from his employment.

Gambling winnings

2.164 Observations may be made in relation to gambling which are parallel with those made in relation to prizes. Questions arise as to what will amount to a business of gambling, and as to whether gambling will be regarded as incidental to a business which is not a gambling business.

2.165 Martin (1953) 90 C.L.R. 470 is the leading Australian authority on what will constitute a business of gambling. It is considered later in relation to Proposition 14. There is a statement in the judgment in Martin that “the taxpayer is not by occupation a bookmaker or trainer or jockey”. The statement, presumably, was intended to dispose of any suggestion that gambling was incidental to some employment or business of the taxpayer. It may be an instructive exercise to consider the circumstances in which gambling on horse races will be held to be incidental to an employment or business as a bookmaker, trainer or jockey.

Proposition 10: A capital gain does not have the character of income

2.166 This is the third of the general negative propositions. There is a disposition, in some of the authorities, to refer to any gain which is not an income gain as a capital gain. The use of the word capital in this way is not helpful. If this usage were adopted, Proposition 10 would merely assert that a non-income gain is not income. It would not assist in setting the limits of the positive propositions.

2.167 When it is said of the income tax that the base is less than comprehensive because it does not embrace capital gains, the meaning of the word capital is that intended in Proposition 10. A capital gain in this meaning is a gain from the realisation of an asset where the gain does not arise in the carrying on of a business or the carrying out of an isolated business venture. Proposition 10 thus defines some of the limits of Proposition 14. There may be no relevant business and no relevant
business venture, in which event the gain is sometimes referred to as a casual gain. Where there is a business to which the gain relates, it is generally said that the gain will be a capital gain if the asset is a capital asset of that business. The most obvious illustrations are the factory premises and plant of a manufacturing business.

2.168 The use of the word “capital” in the phrase “capital asset of a business” is accepted, though a preferable word may be “structural”, if used in a metaphorical sense. There is, however, a risk of confusion. In the ultimate analysis, identifying an asset as a capital asset of a business simply expresses a conclusion that the realisation of the asset was not an aspect of the carrying on of the business. It may be convenient to describe an asset as a capital asset if the realisation of that asset will not, in ordinary circumstances, be an aspect of carrying on a business. But in the context of an actual transaction the asset may be incorrectly described. The leading case is Rolls-Royce Ltd v. Jeffrey [1962] 1 W.L.R. 425 in which the realisation of know-how developed by a business, was held to give rise to income in the context of the actual transaction. Know-how, in ordinary circumstances, would be properly described as a capital asset. Later in this chapter the phrase “revenue asset” is adopted to describe an asset of a business which, on realisation, will in ordinary circumstances give rise to a gain which is income. Here, also, in the context of an actual transaction, the description may be shown to be inappropriate. The realisation of the stock in trade of a business, in ordinary circumstances revenue assets, will not give rise to a gain which is income by ordinary usage, if the realisation is by way of a sale of the business to another, or, perhaps, by way of a sale in a single transaction of all the stock in liquidation.

2.169 Where there is no relevant business and no relevant isolated business venture, an asset is referred to as a capital asset, and the gain on realisation as a capital gain. The alternative phrase “casual gain” may be preferable; it helps to distinguish such a gain from the capital gain arising from the realisation of a business asset.

2.170 Where the realisation of an asset is an aspect of carrying out an isolated business venture, the gain will be income by ordinary usage. At least this is the view of the law taken in Chapter 3 of this Volume. It is a view which equates the phrase “isolated business venture” with the phrase “adventure in the nature of trade” used in the United Kingdom income tax legislation, and treats the authorities on the interpretation of the latter phrase as authorities on a part of the meaning of income by ordinary usage. The asset realised in carrying out an isolated business venture will not be described as capital, nor will the gain be described as a capital gain.

2.171 Section 25A(1) (formerly s. 26(a)), considered at length in Chapter
3, has some effect in giving the character of income to gains from the realisation of property, where the realisation is not an aspect of any business, whether a continuing business or an isolated business venture. It is said of s. 25A(1) that it makes some capital gains income. The intention of this statement is to assert that s. 25A(1) extends beyond the range of the ordinary usage notion of income in relation to the realisation of assets. The same observation may be made of s. 26AAA, also considered in Chapter 3. A recognition that s. 25A(1) carries the meaning of income for the purposes of the Assessment Act beyond the meaning of income by ordinary usage appears in the judgments of Gibbs C.J. and Mason J. in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355. The recognition is important as a rebuttal of a view that received strong expression in *McClelland* (1970) 120 C.L.R. 487. That view would have treated s. 26(a) as no more than a statement of some part of the ordinary usage meaning of income. The view of Gibbs C.J. and Mason J. asserts that s. 25A(1) has no operation where it may, in its terms, overlap the ordinary usage meaning of income. The view is important in rebutting any suggestion that, in an area of overlap, s. 25A(1) exclusively states, and may limit, that part of the meaning of income in the Assessment Act that is taken from the ordinary usage meaning of the word.

**Proposition 11: A gain which is one of a number derived periodically has the character of income**

2.172 This is the first of what might be called the positive propositions (Propositions 11–15), which seek to specify the circumstances in which a gain derived will have the character of income. The scope of a number of these propositions has already been the subject of some exploration in the examination of the general negative propositions (Propositions 8–10), which have the role of defining the outer limits of the positive propositions.

2.173 Two reservations in regard to Proposition 11 should be made. The word “gain” is used to keep faith with Proposition 4, which asserts that gain is an essential feature of the character of income. It has however already been conceded in this Volume that purchased periodical receipts involve an exception to Proposition 4, and to this extent the use of the word “gain” in Proposition 11 is inappropriate. Periodical receipts, though purchased, will be income to the extent in each instance of the whole amount of a receipt. Where the question is whether there is an item of income by ordinary usage, there will not be any allowance against a receipt of any part of the amount of money outlaid, or of the value of property outlaid, in the purchase of that receipt. It will be seen that s. 27H, as a
specific provision defining income, may be taken to require such an allowance and, to the extent of its operation, it adopts gain as an essential element in the notion of income under the Assessment Act. If s. 27H, in this respect, could be taken to express a general principle, it would be a valuable contribution to consistency and good sense. But s. 27H, it will be seen, has a restricted operation. There are other instances of receipts included in income without abatement for any outlay that may have generated those receipts. Principally they concern royalty receipts, discussed in [2.309]–[2.366] below. The second reservation in regard to Proposition 11 is that the word “periodically” must be understood in a special sense, so as to reflect the outcome of the examination which is now undertaken of the circumstances in which receipts in a series will be income. What is attempted is a statement of a principle of periodicity giving the quality of income to receipts in a series. Some part of that statement must be by way of recalling one of the general negative propositions, and by the assertion of a particular negative which set limits to the principle of periodicity. The general negative proposition in relation to gifts may be expressed in the present context as a proposition that a series of mere gifts are not income. The particular negative, which will call for elaboration, is that a series of instalment receipts of an amount that would not be income if received in one sum, are not income.

2.174 The periodicity which will attract the operation of the periodicity principle must be distinguished from periodicity which may be relevant in attracting the operation of another principle. Thus, the fact that there is a series of receipts may, with other circumstances, bring about the operation of Proposition 12—a gain derived from property has the character of income. A receipt that is one of a series is the more likely to be held to be interest, rent or royalties, and income in that character, rather than a gain on the realisation of the property itself, in which character it may not be income. A receipt that is one of a series is the more likely to be found to be income as compensation for income receipts, more especially income receipts that would have been derived from an asset that has been realised or surrendered or of which the taxpayer has been deprived: Proposition 15 is applicable. A receipt that is one of a series is the more likely to be found to be income as a gain which is a reward for services rendered, more especially if the services are rendered under a contract for a continuing supply of services: Proposition 13 is applicable. In these instances periodicity is not a necessary condition of the operation of the principle. It is no more than an indication that the principle is applicable, and the periodicity that is such an indication need not be the periodicity that will attract the periodical receipts principle. The question of dimension of the

**The principle of periodicity**

**A series of mere gifts**

2.175 The examination of *Dixon* (1952) 86 C.L.R. 540, in [2-144]–[2-156] above, suggests that a series of gifts may attract the principle of periodicity, where they are made for the purpose of being receipts on which the receiver depends for regular expenditure upon himself and his dependants, and the receiver in fact depends on the gifts in this way. The notion of income thus reflected is not accretion to economic power, but a notion that is reflected in usage of the word income when it is said of a person that he has covenanted, or been ordered, to make payments which will provide an income for the maintenance of a spouse from whom he has separated; or when it is said that a student has scholarship income; or when it is said that a beneficiary under a will has been provided with an income by being given an annuity; or when it is said that a person has secured for himself an income by joining a superannuation scheme which will pay him a pension, or by buying an annuity from a life insurance company.

2.176 *Dixon* concerns a series of receipts. There is no suggestion of a principle that the receipt of a single isolated payment is income if it is made to provide the receiver with money which he might use for expenditure upon himself and his dependants. Periodicity in fact is thus a necessary, though not a sufficient condition of the operation of the periodicity principle. It is not sufficient because periodicity, while it may indicate, does not establish that the receipt is intended by the payer to be used by the receiver for regular expenditure, and will be relied on by the receiver. The question of dimension, beyond some observations in *Harris* (1980) 80 A.T.C. 4238, has not been examined in the authorities. Bowen C.J. in that case remarked that the receipt was not one of a kind that was periodical within the year, but it is not clear whether the reference is to periodicity in relation to the periodical receipts principle or the compensation receipts principle (Proposition 15). The dimension of periodicity, for purpose of the periodical receipts principle, must be drawn from the underlying notion of “an income”. The underlying notion would not embrace a number of receipts, perhaps on successive days, of a short period. Nor would it embrace a very few receipts spanning a long period of years. Beyond observations of that kind, any series of receipts should, as a
matter of dimension, qualify as periodical.

Covenanted payments; maintenance payments under an order for maintenance; scholarship payments; payments of an annuity under a will; pension payments from a superannuation fund; purchased annuity payments

2.177 The principle of periodicity, as it is found in the judgment of Dixon C.J. and Williams J. in *Dixon* (1952) 86 C.L.R. 540, appears to require an actual dependence by the taxpayer on the receipts for regular expenditure upon himself and his dependants, and a purpose in the payer that they be used in this way. The prospect is that the principle will not operate if it is shown that the taxpayer had other receipts upon which he in fact depended, so that he had no need of the receipts claimed to be income. This aspect of the principle is the subject of the observation by Bowen C.J. in *Harris* that it seemed to discriminate against those with lower incomes.

2.178 Actual dependence on receipts claimed to be income and a related purpose of the payer, have not been regarded as an aspect of the periodicity principle where the receipts come to the taxpayer not as gifts, but as a matter of right. Payments under a covenant to make a series of payments, or under a maintenance order, payments under a scholarship, payments as an annuity left by a deceased person under his will, pension payments by the trustees of a superannuation fund and annuity payments by a life insurance company, will be income within the periodicity principle without any showing of dependence, or purpose. The form of the receipts as a series of receipts will in these circumstances be sufficient to give them an income character. This sovereignty of form may express an assumption that receipts of these kinds are ordinarily used by the taxpayer for regular expenditure upon himself and his dependants, and are ordinarily intended to be used in this way, so that an objective inference of purpose and dependence may be drawn. In this there is some rewriting of the periodicity principle as it may appear in the *Dixon* judgment.

2.179 The operation of the periodicity principle so as to give an income character to receipts may rest on their form as a series of receipts only when there is no other element of form that points to a different conclusion. A will may direct a series of payments to a beneficiary. There may be problems arising out of the interplay of the ordinary usage notion of income and the provisions of Div. 6 of Pt III, more especially when the payments are directed to be made out of income of the deceased estate, or are in fact made out of such income. Those problems are not considered in this Volume. The present concern is with the operation of the principle of periodicity where the series of payments may, because of the language used and of the directions given for payment, be regarded as in form
payments of a legacy by instalments. There is a competition of forms, and on the authorities in connection with payment of a purchase price by instalments considered under the next heading, it will be necessary to resolve the competition by reference to the substance of the periodicity principle.

2.180 The distinction between form and substance in this context, as in any other, cannot be precisely drawn. A statutory provision may employ words of precise meaning in ordinary language, or words that have been given precise meaning by a legacy of judicial interpretation such that they are already words of legal art at the time of enactment. In these circumstances form may be said to prevail, and rightly prevail, where the legal consequences for which the law provides are attached to any circumstances that are within the words employed by the statute. Primary form may be said to prevail. Thus s. 26(f), considered in [2.309]ff. and [4.114]ff. below, provides that an amount received as “royalties” is income. If the word royalties is a term of legal art, any receipt that is within its meaning will be income. There is no room for examination of the substance of any principle. Where a statutory provision expresses a broad principle, it will not employ words of precise meaning in ordinary language, or words of legal art. There is then no scope for primary form to prevail. There is room for form to prevail only where the broad principle is reduced in the process of judicial interpretation to rules which are expressed in words of precise meaning in ordinary language, or words of legal art. Form might be said to prevail, in this event, if the consequences for which the law provides are attached to any circumstances that are within the words of the rules. The form that prevails might be described as extended form, and, in the view of this Volume, it does not rightly prevail wherever the rule is an imperfect expression of the broad principle. When it is said that substance should prevail, there is a direction to return to the broad principle. Thus, it will be seen in Part II, the broad principles expressed in s. 51(1) have tended to be expressed in judicial interpretation in rules that employ words of precise meaning in ordinary language, or words of legal art. Extended form prevails and substance is ignored if a rule that in the circumstances is an imperfect expression of the broad principle is applied.

2.181 Where the law is expressed in the statute only by the word “income” in s. 25, thus importing ordinary usage notions, there can be no primary form that might prevail. Judicial interpretation may have established a rule that items in a series of receipts are income, but that rule should never be more than a prima facie test of the income character of a receipt. Extended form should not be seen as sovereign. At least when there is competition with some other extended form, the character of a series of receipts calls
for a wider investigation. It would be said that the substance of the matter must be considered. Substance may prevail over form or it may reinforce the conclusion directed by form. The substance that prevails is the broad principle in its application to the circumstances. In the present circumstances it is the notion of “an income”.

2.182 In the instance of a will directing a series of payments to a beneficiary, there need not be a competition of forms. The form of a legacy payable by instalments could not be said to be present unless the administrator of the estate is required to set aside an amount, and to pay all of what has been set aside to the beneficiary or to his estate, albeit by a series of payments. If it is directed that the payments will cease if the beneficiary dies, the form is not satisfied. And if the will directs payments equal to the amount set aside even though the assets in which the amount is invested prove inadequate to support those payments, again the form of a legacy payable by instalments is not satisfied.

2.183 Where the form of payment of a legacy by instalments is satisfied, the substance of the periodicity principle may yet require examination. The point has been made that the relevant substance is not necessarily that suggested by the Dixon judgment. If actual dependence on the receipts by the receiver is an essential aspect of the principle of periodicity, it will be necessary to make a separate characterisation of each receipt, as it is received, and the curious consequence will follow that a taxpayer may have income and be subject to tax because he has come to be in need of the receipt. It may be thought that the relevant substance should be the purpose of the payments in a series, determined objectively. The series of receipts will be income if their purpose may be said to be to provide the taxpayer with money on which he might rely for regular expenditure on himself and his family. In the context of a series of payments directed by a will, the frequency of payments and the period over which they are to be made, may yield an inference of that purpose.

2.184 There is some discussion in the authorities of the significance of a description of a series of payments as an annuity in the terms of the transaction or document by which the right to the payment arises. The description may confirm what is likely to be evident in any case—that payments are to be made in a series—but it does not bear on the substance of the matter. This is the effect of the judgment of Cross J. in Vestey v. I.R.C. [1962] Ch. 861 rejecting a suggestion in Foley v. Fletcher (1853) 3 H. & N. 769; 157 E.R. 678 that the description of a series of receipts as an “annuity” must bring them within the periodicity principle.

Instalment receipts of an amount that would not be income if received in a single
The greatest difficulties in defining the scope of the periodicity principle arise in relation to a particular negative proposition which would assert that a series of receipts is not income where they are instalment receipts of an amount that would not be income if received in a single sum.

There is an initial question as to the validity of this negative proposition. In the discussion of a similar negative proposition—a series of receipts is not income if they are instalment receipts of a legacy—under the last heading, the assumption was made that a conclusion that the receipts are instalments merely raises a competition of forms which will have to be resolved by resort to substance. A like assumption may be appropriate here, so that the negative proposition should be read as leaving the substance of the periodicity principle to operate if it should be concluded that the purpose of making the payments by instalments was to provide the taxpayer with money on which he might rely for regular expenditure on himself and his dependants.

The difficulties arise in circumstances (i) where there is an existing debt (arising from a loan or other transaction) which is not on revenue account and an agreement is entered into by which the debt is discharged in a manner which involves a series of payments, and (ii) where property is sold or rights are surrendered for a consideration that involves a series of payments, and the property is not a revenue asset.

The exclusion of revenue account and revenue asset situations in this formulation, is necessary to limit the circumstances to those in which a single sum receipt would not be income. The notions of revenue account and of revenue asset are discussed in connection with Proposition 14 in this chapter, and in later chapters.

One of three possible analyses may explain the circumstances of a particular case:

(1) There is a series of payments and a discharge by those payments of an indebtedness of a fixed amount, or of a fixed amount being the purchase price of property, or of a fixed amount being the consideration for the surrender of rights. The payments are payments of the fixed amount. There is thus a competition of forms.

(2) There is a series of payments and a discharge of the fixed amount of a debt or the purchase price of property, or the fixed amount of consideration for the surrender of rights. The discharge does not, however, arise from the making of the series of payments. The discharge has already occurred as a result of the application by the creditor of his entitlement to payment of the debt, purchase price, or consideration for the surrender of rights in the purchase of the series of payments. The form of
instalment payments of a fixed amount is thus not present. There is only one relevant form—a series of payments.

(3) There is a series of payments which have been purchased by the outlay of property, or by the surrender of rights. Where this analysis applies, there is only one form that is appropriate—a series of payments.

Where there are two distinct transactions—the one by which a right to payment of a fixed amount arises, and the other, a later transaction, by which that entitlement is applied in the acquisition of a new entitlement to a series of payments—the second analysis is clearly appropriate. The right to payment of a fixed sum has ceased to exist, and a new right to a series of receipts has arisen. Where two transactions appear to be telescoped into one, so that at the same moment a right to a fixed sum arises and is converted to a series of receipts which may be more, or may be less, in total than the fixed sum, the second analysis is not so obviously appropriate. But it might be thought to be appropriate, or, more likely, that the third analysis will be appropriate unless the fixed sum mentioned in the transaction continues to control in some respect the total amount that may be received under the right to the series of receipts. If it does control, the first analysis will be appropriate.

2.190 The United Kingdom cases reflect some concern to hold, if possible, that the first analysis is appropriate, and to resolve the completion of forms in favour of the form of instalment receipts. This concern may be moved by an unwillingness to allow too much room for an aspect of the ordinary usage notion of income which may include in income an amount that is not a gain. The United Kingdom cases that are concerned with the periodicial receipts principle are complicated by provisions of the United Kingdom legislation, by which the periodical receipts principle may be used in effect to shift income from the payer to the receiver. This was the effect, in relation to income tax, of the transaction with which *I.R.C. v. Church Commissioners for England* [1977] A.C. 329 and *I.R.C. v. Land Securities Investment Trust Ltd* [1969] 1 W.L.R. 604 were concerned. Church Commissioners were not unhappy about the operation of the periodical receipts principle to make their receipts income, for they were an exempt body, and were entitled to a refund from the Revenue of tax they were deemed to have paid on those receipts.

2.191 The relevant provision of the United Kingdom legislation is s. 52 of the *Income and Corporation Taxes Act* 1970. There have been equivalent provisions in the United Kingdom legislation for most of its history. It does not apply to a company subject to corporation tax. It will be noted that Land Securities was subject to income tax and profits tax, which at that time applied to the income of companies. The effect of s. 52 is that where
“an annuity or other annual payment” subject to income tax in the hands of the receiver is payable out of profits subject to income tax in the hands of the payer, the payer is entitled on making the payment to deduct and retain out of the payment a sum representing the amount of income tax thereon. The receiver must submit to this deduction by the payer and is deemed to have received the amount deducted. The amount deducted is, however, deemed to be income tax paid to the Revenue by the receiver. The procedure does not involve a withholding tax. The payer is entitled to retain, as against the Revenue, the amount deducted. He remains liable to income tax, however, on the amount of the profits out of which the payment was made.

2.192 The procedure will explain the form of the proceedings in some of the United Kingdom cases. In Church Commissioners the taxpayer, being a charity and exempt from tax, sought to recover from the Revenue the amount of tax it claimed was deemed to have been paid to the Revenue, and the question was whether the Church Commissioners had received annual payments that were income in their hands. In an Australian context, it might be thought curious that a taxpayer was asserting that it had derived income. In Foley v. Fletcher (1858) 3 H. & N. 769; 157 E.R. 678 the seller of property sought to recover from the buyer who was liable to make payments to her, the full amount of those payments, asserting that those payments were not annual payments subject to the income tax in her hands, but instalment payments of the sale price. The buyer was not therefore entitled to deduct and retain out of each payment a sum representing the amount of income tax on it. An income tax issue was thus raised in proceedings that did not involve the Revenue. In Vestey v. I.R.C. [1962] Ch. 861 the proceedings were between taxpayer and Revenue but concerned not income tax but surtax—an additional levy of tax on income, to which the s. 52 procedure had no application. The taxpayer claimed that the receipts in respect of shares sold were instalment receipts of the price payable for the shares, and not annual payments. In this instance the taxpayer was asserting he had not derived income, and the proceedings are not curious if seen in an Australian context. The proceedings in Secretary of State in Council of India v. Scoble [1903] A.C. 299 were like those in Foley v. Fletcher. The person entitled to the payments claimed they were not income as annual payments, and he was entitled to recover their full amount: the Secretary of State was not entitled to deduct an amount representing income tax. I.R.C. v. Ramsay (1935) 20 T.C. 79 was concerned with the liability to surtax of a person making payments in respect of the purchase of a dental practice. At the time of the payments, amounts paid that were annual payments and income of the receiver were
deductible by the payer in the determination of his liability to surtax. The
issue was one between the payer and the Revenue, not as to whether the
payer was entitled to “deduct and retain” as against the receiver under the
s. 52 procedure, but as to whether the payer, as against the Revenue was
entitled to a deduction, in the Australian sense of an allowable deduction,
of the payments he had made to the seller of the practice.

2.193 Land Securities Investment Trust Ltd [1969] 1 W.L.R. 604
cconcerned the company's liability to profits tax—a tax now replaced by
corporation tax. The fact that the payments made to the Church
Commissioners were, as ultimately found, annual payments and income of
Church Commissioners was irrelevant in determining the amount on which
Land Securities was subject to profits tax. The question was whether Land
Securities was entitled to deductions—in the Australian sense of allowable
deductions—against the Revenue of the amounts paid. That question had to
be resolved in terms of whether the payments were revenue expenses of
deriving the rents from the reversions Land Securities had acquired from
Church Commissioners, or were expenses of acquiring those reversions
and thus capital expenses.

2.194 The Australian cases, Just (1949) 23 A.L.J 47 and Egerton-
Warburton (1934) 51 C.L.R. 568 may be thought to show little reluctance
to let the periodicity principle operate, and this notwithstanding that s. 27H
(or its earlier equivalent) was held in each case not to be available to
correct an operation of the principle which will include in income an
amount that is not a gain.

2.195 The United Kingdom cases, in seeking to find the first analysis
appropriate, rather than the second or third, have given almost ritualistic
significance to the mention in the transaction of what is called “a fixed
gross sum”. There will always be a fixed sum indicated where the
payments are made to discharge an existing debt, and it is highly likely that
there will be a specification of a fixed sum in the case of a sale of property
or a surrender of rights, more especially when the legal adviser to the seller
has read the cases. Where there is a fixed sum, and the payments to be
made are certain in amount and number, Foley v. Fletcher (1853) 3 H. &
N. 769; 157 E.R. 678 is acknowledged authority that the payments are
instalment payments of that fixed sum, whether or not there can be said to
be any obligation to pay the fixed sum, as distinct from an obligation to
make the series of payments: the fixed amount may not in any respect
control the right to the series of payments.

2.196 And Foley v. Fletcher must be taken to have decided that where
payments are certain in amount and number, and they are expressed to be
payments of a fixed gross sum being the purchase price of property, the
form of instalment payments of the purchase price of property prevails, and there is no room for the operation of the periodicity principle.

2.197 *Foley v. Fletcher* is in some contrast with the Australian authority in *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144. As in *Foley v. Fletcher* there was mention of a fixed sum, but this, Dixon and Evatt JJ. observed, was only the “arithmetical equivalent” of the payments to be made (at 156). Default in payment of any of the agreed amounts would not have brought the fixed sum into operation, for example by requiring payment of the balance forthwith as in the United Kingdom decision, *Vestey v. I.R.C.* [1962] Ch. 861. *Phillips* is thus authority for Australia that the mere mention of a fixed sum does not exclude the second or third analysis. *Phillips* may differ from *Foley v. Fletcher* in another respect. Even if there had been a provision in the agreement for repayment forthwith of the balance on default in payment of any one amount, so that the fixed sum controlled, the court might yet have been disposed to find that the competition of forms should be resolved by holding the receipts to be periodical.

2.198 The phrase “fixed gross sum” is misleading in the inclusion of the word “gross”. It might indeed suggest the arithmetical sum of a series of payments which *Phillips* rejects as having no relevance. The phrase appears in a much quoted passage from the judgment of Walton J. in *Chadwick v. Pearl Life Insurance Co.* [1905] 2 K.B. 507 at 514:

“It is obvious that there will be cases in which it will be very difficult to distinguish between an agreement to pay a debt by instalments, and an agreement for good consideration to make certain annual payments for a fixed number of years. In the one case there is an agreement for good consideration to pay a fixed gross amount and to pay it by instalments; in the other there is an agreement for good consideration not to pay any fixed gross amount, but to make a certain, or it may be an uncertain, number of annual payments. The distinction is a fine one, and seems to depend on whether the agreement between the parties involves an obligation to pay a fixed gross sum.”

The reference at the end of the passage to “an obligation to pay a fixed gross sum” may suggest some questioning of *Foley v. Fletcher*. In *Vestey v. I.R.C.* [1962] Ch. 861 there was clearly a continuing obligation to pay the fixed sum—albeit a sum calculated by adding together the payments in the series—for there was provision for payment of the balance of the sum, if there was default in payment of any instalment. Cross J. accepted *Foley v. Fletcher* as authority that bound him to hold that periodicity did not apply on the facts before him. In the course of his judgment he said (at 874): “... I do not think that the fact that the period here is far longer than that in *Foley v. Fletcher* is a good ground of distinction between the cases.
The question, as I see it, is one of principle not of degree.” It might be thought that degree is an aspect of principle. A long term of payments favours periodicity in the resolution of a competition of forms by reference to the substance of the periodicity principle.

2.199 In *Foley v. Fletcher* the second possible analysis would have been appropriate. The fixed sum could have been regarded as having been applied as the price of the series of payments. The case is authority against such an analysis where the payments are certain in amount and number. And it is supported in this respect by *Secretary of State in Council of India v. Scoble* [1903] A.C. 299. United Kingdom authority has, however, contemplated the application of the second analysis where the payments are not certain in number or amount. The leading case is *I.R.C. v. Ramsay* (1935) 20 T.C. 79. All members of the court thought it important to consider in what sense the payments, which were based on the profits of a professional practice, could be said to be instalment payments of the fixed sum specified as the sale price of the practice. The purchaser would in some events have been called on to pay an amount which would be the difference between the fixed sum and the total of the payments that had been made up to the time of the event. The fixed sum thus “controlled” the series of payments. It was not “otiose” or “redundant” or “surplusage”. It was a figure which “permeated” the whole contract.

2.200 On the question of how a competition of forms is to be resolved, *I.R.C. v. Ramsay* is unhelpful. Lord Wright's reference to the substance of the transaction suggests that the competition could still have been resolved in favour of the application of the periodicity principle. Romer and Greene L.JJ., on the other hand, would appear to take the view that once the competing form is established, periodicity is excluded.

2.201 Where the number or amount of the payments is uncertain and the debt or fixed sum will not in any circumstances control what has to be paid, as in *Dott v. Brown* [1936] 1 All E.R. 543, the second or third analysis is clearly appropriate. In *Dott v. Brown* the agreement provided for discharge of an existing debt by an undertaking to make a series of payments. The payments would continue until the death of the creditor, but cease at that time. The only relevant form was a series of receipts, and at first sight that series was indistinguishable from a life annuity payable by a life insurance company. Yet the Court of Appeal held that the receipts did not attract the periodicity principle. The judgment of Scott L.J. with which the other members of the court agreed, is punctuated with assertions that the character of the receipts had to be determined by reference to the substance of the matter. He said (at 548): “A consideration of the cases shows that you have to examine the details of the particular transaction out
of which the payment arises and make up your mind as to the substance of it—the reality of it.” The case is thus authority that the absence of any competing form does not require that a series of receipts should be treated as periodical, at least where there is a pre-existing debt which is discharged in the transaction out of which the receipts arise.

2.202 The assertions of the need to look at substance are not however accompanied by any indication of what it is in the substance of the law that will justify treating a series of receipts as attracting the periodicity principle. If the relevant substance is that suggested by the judgment in Dixon (1952) 86 C.L.R. 540, more especially if it is only a matter of requiring an objective inference of dependence and purpose, the conclusion reached by the Court of Appeal is difficult to support.

2.203 Where the payments are held not to be periodical because the competing form of instalment payments of a fixed sum prevails, a question arises as to whether any part of a payment may be treated as income of the person receiving it, as interest, within Proposition 12. Part of each receipt was treated as income for this reason in Secretary of State in Council of India v. Scoble [1903] A.C. 299, Vestey v. I.R.C. [1962] Ch. 861 and Beck v. Lord Howard de Walden (1940) 23 T.C. 384. The matter is considered further in the discussion of Proposition 12.

2.204 The third possible analysis involves a series of payments which are themselves the consideration for the sale of property, or the consideration for the surrender of rights. The only relevant form is a series of receipts. Two Australian cases Just (1949) 23 A.L.J. 47 and Egerton-Warburton (1934) 51 C.L.R. 568 and one United Kingdom case, I.R.C. v. Church Commissioners for England [1977] A.C. 329 admit of this analysis. In all of them the receipts were held to attract the periodicity principle. In Church Commissioners property was sold for a rent charge. At some stage of the negotiations a present value of the rent charge was calculated, but the agreement did not in its terms provide for payment of this amount. In Just there was mention in the agreement of an amount as the value of the property for stamp duty purposes, but no provision of the agreement required payment of this amount. In Egerton-Warburton there was no mention of a fixed amount in any connection.

2.205 There is some acknowledgment in these cases of the significance that might have been given to the mention of a fixed sum as a purchase price. Webb J. in Just seems to have thought that this would necessarily have excluded the principle of periodicity, even though the second analysis was appropriate. It has been seen that a ritual significance in the mention of a fixed sum is not a necessary conclusion at least from the Australian authority in C. of T. (Vic.) v. Phillips (1936) 55 C.L.R. 144.
The question remains whether the form of a series of receipts is sovereign when there is no alternative form because the third analysis is appropriate. *Dott v. Brown* may be seen as persuasive authority that it is not. It is yet possible to conclude that, in substance, the series of receipts are not within the periodicity principle. The payments in *Egerton-Warburton*—an annuity to a father who had sold his farm to his sons—were clearly within the substance of the periodicity principle, if this is a matter of objective inference of dependence and purpose. And the payments in *Church Commissioners* may be within the substance of the periodicity principle if that principle is adapted to the situation of derivation by an entity that is a charity. Some further adapting of the substance of the principle will be necessary so that a trustee might be held to derive receipts that are within that principle. *Just* creates more difficulty. The relevant substance, however it is adapted, does not appear to be engaged. It may be that there is another aspect of the periodicity principle which will explain *Just*: where the amounts of a series of payments are calculated by reference to income receipts of the payer, the income quality of the receipts by the payer may be transferred to the series of payments. In *Cliffs International Inc.* (1979) 142 C.L.R. 140, Barwick C.J. ventured an observation that where a taxpayer has sold shares in exchange for payments calculated by reference to the exploitation of mining rights owned by the company whose shares were sold—an amount per ton of ore taken—the payments when received will be his income (at 151). There may be another basis—in Proposition 12—for a conclusion that the receipts in *Cliffs* are income but the character of the receipts in *Just* will continue to require explanation. *Just* involved payments of an amount calculated by reference to income being rents derived by the payer from property which was only in part the property sold. In *Cliffs* the payments were calculated as a fixed amount per ton of ore taken from the mine. In fact the purchaser did not itself work the mine: the payments were made from royalty income it received from others who were licensed to work the mine. *Just* and *Cliffs* in the explanation presently considered, might draw support from *Jones v. I.R.C.* [1920] 1 K.B. 711. The notion of transfer of income character may explain *Just* (1949) 23 A.L.J. 47, *Cliffs* and *Jones v. I.R.C.*, though it does not sit easily with Proposition 3 [2.34]–[2.37], above. It might be thought to be a consequence of that proposition that a payment made to a taxpayer from income derived by another does not carry its income character into the hands of the taxpayer. But where payments are received under an agreement for sharing profits, there is room for an argument that the receipts are for the purpose of providing the receiver with “an income”, and are income of the receiver on the periodicity
principle.

2.207 One might ask whether receipts under a profit sharing arrangement, of the kind with which *Van den Berghs Ltd v. Clark* [1935] A.C. 431 was concerned, will be income of the receiver. The periodicity principle may be wide enough to embrace such receipts. Where the arrangement is reciprocal, so that a taxpayer who receives in one year may in another year be required to make a payment to the other party to the arrangement, deductibility of the payment may be explained on the basis that it is an outgoing in gaining the periodical receipts that are income in other years. Where the arrangement is not reciprocal, deductibility of the payments is difficult to justify. In *Colonial Mutual Life Assurance Society Ltd* (1953) 89 C.L.R. 428 the company making the payments to the person who was the taxpayer in *Just* was denied a deduction of the payments on the ground that they were the price of a structural asset. A deduction was allowed of the payments in *Cliffs* but in the special circumstances that the payments would have to be made over the whole period that the property acquired would be income producing. The special circumstances justified a conclusion that the payments were not made as consideration for the property acquired but for the use of that property. In the latter character, they were working expenses.

2.208 A transaction which is the purchase from another of a series of promissory notes given by that other, is in form the purchase of a series of receipts. There is no competing form, though commercially the transaction would be seen as involving repayments of a loan. One of the transactions in *Beck v. Lord Howard de Walden* (1940) 23 T.C. 384 was of this kind, though there were associated transactions under which promissory notes were given in exchange for the release of obligations owed to the taxpayer by the company giving the notes. Wrottesley J. gave some consideration to the possibility that the receipts in these transactions were wholly income as periodical receipts. In concluding that they were not, he did not give reasons, being content to cite the authority of *Foley v. Fletcher* (1853) 3 H. & N. 769; 157 E.R. 678; *Secretary of State in Council of India v. Scoble* [1903] A.C. 299; *Perrin v. Dickson* [1930] 1 K.B. 107; *I.R.C. v. Ramsay* (1935) 20 T.C. 79. An investigation of the substance of the principle of periodicity would have been helpful. *Perrin v. Dickson* is a case equally lacking in any statement of reasons why the series of receipts were not income, beyond an assertion that they were not income because they were repayments of an investment. That assertion may carry with it an inference that the series of receipts did not have the purpose of providing the taxpayer with “an income”. A similar reason might be given to explain why the receipts in *Lord Howard de Walden* were not income. The
taxpayer in *Perrin* had made a series of payments to a life insurance company, under a contract by which he would be entitled to payments over several years of the life of his son. The payments to be made by the company were calculated so as to give the taxpayer a return of 3 per cent compound interest on the payments he had made to the company. If the son did not survive to the relevant years, the taxpayer was to receive back what he had paid without interest. Lord Hanworth M.R. remarked (at 119):

“I do not feel at all pressed with the observations that the effect of the decision will be to release all annuities for a fixed term of years from income tax. The immunity will be given only in proper cases in which an attempt is being made wrongly to tax capital under statutes which are intended to charge income and income only, for . . . it cannot be taken that the legislature meant to impose a duty on that which is not profit derived from property, but the price of it.”

2.209 If a series of receipts are income as periodical receipts, they will, it seems, be income as to the whole of each of their amounts. There may yet be room for an argument, based on a principle that an item is income only to the extent that it is a gain, which would assert that an outlay to acquire the right to periodical receipts should be spread over the series of receipts and subtracted in determining how much of each receipt is income. It has however been conceded in this Volume that, having regard to the express provisions in s. 27H, such an argument is unlikely to prevail.

2.210 Once it is accepted that receipts are periodical receipts, it is not appropriate to treat any part of a receipt as having the character of interest on an amount receivable. Such an analysis is appropriate only when it has been concluded that the receipts are not periodical receipts. It might be thought to follow that amounts paid which are periodical receipts in the hands of the receiver, do not involve any element of interest paid by the person making the payments. A payment should not be seen as having been made by the payer for the use of the payee's money, unless it is treated as having been received by the payee for the use of the payees' money. In *I.R.C. v. Land Securities Investment Trust Ltd* [1969] 1 W.L.R. 604 such a view was taken by Lord Donovan. The case concerned a question of deductibility by the payer of amounts that were held to be periodical receipts of the payee in *I.R.C. v. Church Commissioners for England* [1977] A.C. 329. Cross J. at first instance had held that the payments could be dissected into capital and interest components for purposes of deciding the question of deductibility by the payer, and the interest component allowed as a deduction. Lord Donovan in the House of Lords (at 612) questioned the conclusion reached by Cross J.:

“Cross J. in the Chancery Division thought that the rent charges could, for the
purposes of tax only, be dissected into capital and interest components and the latter alone allowed as a deduction. In this respect he considered that the present case was similar to *Secretary of State in Council of India v. Scoble* [1903] A.C. 299; and *Vestey v. I.R.C.* [1962] Ch. 861. Like the Court of Appeal I do not think these cases are really in point. In the former a capital sum had been agreed as the purchase price, and the inference could be drawn that the so-called “annuity” was the payment of this sum by instalments together with interest. Cross J. was able to draw a like inference in the latter case. But in the present, it is common ground that no such capital sum was agreed beforehand.”

The conclusion that the payments were periodical receipts thus precluded a conclusion that any parts of them were deductible as interest.

2.211 A conclusion that the payments are periodical receipts in the hands of the payee does not however exclude the possibility that the payments are deductible on some basis other than payments of interest. In *Cliffs International Inc* (1979) 142 C.L.R. 140 the deductibility of the payments can be explained in terms that they were payments for the use of property. That view of the facts offered a basis for a conclusion that they were income of the payee, in addition to the basis that they were periodical receipts of the payee.

**Commutation of periodical receipts**

2.212 *Tilley v. Wales* [1943] A.C. 386 is authority that a single sum received in commutation of periodical receipts is not ordinarily income. The compensation receipts principle (Proposition 15) will not give an income character to a receipt for the relinquishment of a capital asset, and a right to periodical receipts will almost certainly be such an asset.

2.213 The situation is different, however, when the commutation amount itself is a series of receipts. If a taxpayer receiving a pension agrees to accept commutation in the form of a different series of receipts, the new series could be held to be income as compensation receipts, even though the new series would not in themselves be income as periodical receipts—the number of receipts in the new series and the period over which they are to be received may be such that the periodicity principle is not satisfied. A taxpayer may have commuted a life pension for several annual payments, seeking thereby to escape s. 26(d) (now replaced by Subdiv. AA of Div. 2 of Pt III) in its operation on commutation receipts as in *McIntosh* (1979) 79 A.T.C. 4325. There will be questions of how far the new series must approximate the former series for the compensation receipts principle to be attracted. *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144 and, more recently *D. P. Smith* (1981) 147 C.L.R. 578 may assist in answering this question. *Harris* (1980) 80 A.T.C. 4238, considered in [2.147–[2.156]
above offers but little assistance.

2.214 To the extent that a commutation receipt is not income, it affords a means of correcting the tax consequences of having purchased periodical receipts in circumstances to which the “purchase price” provisions of s. 27H—considered in [2.215]ff. and [4.106]ff. below—have no applications. Such a policy justification of a conclusion that a commutation receipt is not income by ordinary usage is not relevant if the periodical receipts that were commuted can be seen as having been an alternative to a single receipt that would have been income. Subdivision AA of Div. 2 of Pt III substantially extends the range of single receipts that are income, by its provisions in s. 27B and s. 27C applicable to payments made in consequence of the termination of any employment of a taxpayer, and payments made from a superannuation fund in respect of a taxpayer. Where the taxpayer receives an annuity that is a termination payment or a payment from a superannuation fund, there is provision within the definition of an “eligible termination payment” (in paras (d) and (g) of s. 27A(1)) by which an amount received in commutation of the annuity is income taxable under the special provisions of s. 27B and s. 27C. Unfortunately, however, para. (g) of the definition, and ss 27B and 27C have the effect of making a commutation receipt in respect of an annuity income where the annuity arose in the circumstances of Just (1949) 23 A.L.J. 47 and Egerton-Warburton (1934) 51 C.L.R. 568. An argument might have been made that there is no “eligible service period” (defined in s. 27A(1)) in such circumstances, and there must be such if s. 27B or s. 27C is to operate. But para. (d)(ii) of the definition of “eligible service period” supplies such a period if the annuity was purchased.

Section 27H: Annuities

2.215 Section 27H(1) (replacing the former s. 26AA(1)) gives the character of income to the amount of any “annuity”, excluding, in the case of an annuity that has been purchased, any amount that is the “deductible amount” in accordance with s. 27H(2) and (3). The deductible amount is calculated by reference to the “undeducted purchase price” of the annuity. “Undeducted purchase price” is defined in s. 27A(1). The general effect of that definition is that the “undeducted purchase price” is the purchase price less any part of that purchase price that has been or will be an allowable deduction. “Purchase price” is defined in terms of payments made to purchase the annuity, or where the annuity is a superannuation pension, contributions to a superannuation fund to obtain the superannuation pension less any part of those contributions that has been or will be an
allowable deduction. A transfer of property, as in Just (1949) 23 A.L.J. 47, will be a payment. This is the effect of subs. (8) of s. 27A, or alternatively, s. 21.

2.216 Two questions are raised by these provisions. The first concerns the possible effect of s. 27H to extend the range of series of receipts which will have the character of income, beyond the range determined by the ordinary usage notion of periodical receipts. The second concerns the possible interpretation of the word “annuity” used in the section so that it involves a more limited notion than the notion of periodical receipts that are within the periodical receipts principle.

2.217 In Secretary of State in Council of India v. Scoble [1903] A.C. 299 and in Perrin v. Dickson [1930] 1 K.B. 107 receipts described in the documents providing for their payment as “annuities” were held not to be periodical receipts. It is apparent that in some usage the word “annuity” has a wider meaning than the notion of periodical receipts. That usage would, possibly, embrace any series of receipts. The prospect that the adoption of a wider meaning would, through s. 27H, increase the operation of the law in bringing in amounts which are not gains, is likely to inhibit the adoption of that wider meaning for the word as it is used in s. 27H.

2.218 There is some authority which would indicate that the word “annuity” as it was used in s. 26AA(1) had in one respect a narrower meaning than periodical receipts. In Deputy Federal Commissioner of Land Tax v. Hindmarsh (1912) 14 C.L.R. 334, a case concerned with the use of the word in a statute imposing land tax, the High Court held by majority that the word should be given a technical construction drawn from Coke on Littleton, so that it will be confined to a series of receipts each of a sum certain and, presumably, the same sum certain. A like construction of the word in its use in s. 27H would significantly narrow the operation of the “purchase price” provisions of s. 27H. The purchase price provisions would have no application to a series of receipts of amounts indexed by reference to a measure of the purchasing power of money. It may be noted that Kelly J. in Knight (1983) 83 A.T.C. 4096 declined to give the word “annuity”, as it was used in s. 26AA(1), a meaning that would exclude an indexed annuity.

2.219 The drafting of s. 27H may in any event justify a meaning for the word annuity that does include a series of receipts whose amounts are not sums certain. Section 27H(4) defines annuity for purposes of the section so that it includes “a superannuation pension”. A superannuation pension may be an indexed pension, and this circumstance may justify a meaning of the word annuity in other contexts that will include amounts that are not sums certain. At least this is one line of reasoning. It would be conceded that
another line of reasoning is possible that would argue that the express inclusion of superannuation pensions, which are likely to be indexed, indicates an assumption that other indexed periodical receipts are not included by the word “annuity”.

2.220 Webb J. in Just (1949) 23 A.L.J. 47 assumed that the word “annuity” in a section that was a predecessor of ss 26AA and 27H did extend to receipts that were not sums certain. At the same time Webb J. construed the mitigation provisions of the section in a way that restricted their availability. His judgment may be thought to mix two notions of purchase price. It has been seen that where property is sold under an agreement which provides for payment of a series of receipts, those receipts may avoid the character of periodical receipts if there is a fixed sum expressed in the agreement as the purchase price of the property. The absence of any statement of a purchase price in this sense was relevant to Webb J.’s conclusion that the series of receipts were periodical receipts. But the absence of any statement of such a purchase price does not require a conclusion that the periodical receipts did not have a purchase price. The price of the periodical receipts was the land conveyed in exchange for those receipts. That price was not in money, but s. 21 provides that where any consideration is given otherwise than in cash, the money value of that consideration shall be deemed to have been given. There is now, as already noted, an express provision having the same effect in s. 27A(8), in relation to s. 27H.

2.221 It is true that Egerton-Warburton (1934) 51 C.L.R. 568 also involved the conclusion that there was no identifiable purchase price of the periodical receipts. But in that case the land had been sold in exchange for several promises—to pay annuities in succession to the seller and his wife, and to make a payment to be divided among their daughters. It is clear that the High Court was ready to treat the value of the land as undeducted purchase price, but it was unable to apportion that value between the several promises, so as to determine an undeducted purchase price of the annuity to be received by the seller.

2.222 Where the analysis of the circumstances is the second analysis explained in [2.189] above, it may be appropriate to treat the specified fixed sum as the purchase price of the periodical receipts. But in this regard a distinction should be drawn between the two situations referred to in explaining the second analysis. If there are in fact two distinct transactions, the specified fixed amount to which the taxpayer is entitled under the first transaction may be treated as purchase price. But where there are two transactions telescoped into one, treating the fixed amount as the purchase price for purposes of s. 27H will open the prospect of tax planning to
exploit s. 27H so that it is used to preclude the taxing of what are in fact gains. The fixed amount may be set at a figure which will ensure that the element of gain in the periodical receipts will be excluded from tax. The fixed amount may be set at a figure which is equal to the sum of the periodical receipts anticipated. It ought not to be beyond judicial construction of the words “purchase price” in s. 27H to hold in these circumstances that the value of the property sold is the purchase price of the periodical receipts.

2.223 Were it not for words now added to s. 25(1), to which reference was made in [1.39] above, it would be the most likely construction of s. 27H that it is intended to cover the field of receipts that may be income in virtue of their periodicity. It would follow that the ordinary usage meaning of income is displaced to the extent that it would bring about the inclusion in assessable income of that part of an annuity receipt which is not made income by s. 27H—that part which is excluded as a “deductible amount”. The words added to s. 25(1) in 1984, expressly excluding the operation of that section in relation, inter alia, to “eligible termination payments”, might have left the provisions of Subdiv. AA relating to eligible termination payments to operate as a code. But, by inference, they appear to have excluded the possibility that s. 27H operates as a code. The consequence may now be inescapable that a receipt of an amount of an annuity is income as to the whole of its amount, if it is a receipt within the ordinary usage meaning of income, unabated by any exclusion of a part of the purchase price of the annuity.

Section 262: Payments “really in the nature of income”

2.224 The operation of s. 262 of the Assessment Act in determining whether the whole or part of a series of receipts is income is not the subject of any judicial decision. The section applies “Where under any contract agreement or arrangement . . . a person assigns, conveys, transfers or disposes of any property on terms and conditions which include the payment for the assignment, conveyance, transfer or disposal of the property by periodical payments”. It would appear, on a literal reading, to give the Commissioner a power to attribute the quality of income to the whole or part of such payments by forming the opinion that they are wholly or in part “really in the nature of income”. The section was not referred to in *Egerton-Warburton* or *Just*. The predecessor of the section in the 1922 Act was the subject of a submission in *Californian Oil Products Ltd (In Liquidation)* (1934) 52 C.L.R. 28, but the judgments in that case provide no assistance in the interpretation of the section.
2.225 It may be assumed that the section would not be construed so as to give the Commissioner a power to attribute the quality of income to a receipt. The section must however have some operation in displacing *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341 discussed in [2.558]-[2.570] below in relation to Proposition 15, which allow very little room for separating out an income element from a composite receipt. In this operation the section may enable the Commissioner, despite *McLaurin* and *Allsop*, to follow United Kingdom authority so as to separate out and bring to tax an interest element in an instalment payment of a purchase price of property, or perhaps in an instalment payment of a debt.

Section 23(1): Alimony or maintenance payments

2.226 Section 23(1) assumes that payments by way of alimony or maintenance will be income in the hands of the receiver as periodical receipts, and makes them exempt where they are received by a woman from her husband or former husband. The effect is to preclude what might be thought to be double taxation, when the husband has made the payments out of income which has been taxed to him. There is a proviso which denies the exemption when the payments are in effect made from income that has not been taxed to the husband. He may have shifted income by transferring to a trustee property which produces the income, or by making an assignment of income. The assignment will defeat the exemption only when the husband has “diverted from himself income upon which he would otherwise have been liable to tax”. The tax consequence of assignments is considered in Chapter 13. If the form of assignment adopted brings about a derivation of income by the husband, the exemption will not be affected.

2.227 The section does not deal with payments received by a man from his wife or former wife, though the assumption in the section that such receipts are income in the case of receipt by a wife from a husband may be thought to extend to a like receipt by a husband from his wife. In form the receipts are a series and there is no competing forms. If an element of substance must be satisfied, the purpose of the payments may be seen as providing the receiver with money on which he might depend for regular expenditure upon himself.

Proposition 12: A gain derived from property has the character of income
2.228 The operation of the principle that a gain derived from property is income is consistent with Proposition 4, though inflation may cause distortion in this context, as in others. The effect of inflation is considered generally in Chapter 15. The whole amount of interest received will be income notwithstanding that there has been a decline in real terms of the value of the principal sum. Indeed the whole amount will be income notwithstanding that the interest is less than the decline in value of the principal sum, so that in effect the taxpayer has suffered a loss.

2.229 The principle reflects a metaphor which has its origin in the experience of an agricultural community. It expresses what, in the Memorandum of Dissent contained in the United Kingdom Royal Commission's Final Report (p. 358), referred to in [1.47] above, is identified as “the ancient constricted conception of income as something which recurrently emerges and is separated off from its perpetual source, like the harvest from the soil, [which] has lingered in the tax code from times when, by and large, income was the harvest from the soil”.

2.230 The metaphor is very evident in a frequently quoted passage from the judgment of Pitney J. in the United States Supreme Court in Eisner v. Macomber 252 U.S. 189 (1919) at 206-7:

“The fundamental relation of ‘capital’ to ‘income’ has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time . . .

. . . Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital however invested or employed, and coming in, being ‘derived’, that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property. Nothing else answers the description.” (Emphasis in original.)

2.231 The metaphor would suggest a principle wide enough to embrace gains which are not simply returns to an owner who waits passively for his return from property, but involve an input of effort to make the property yield a return, or to increase that return. Where gains arise at least in part from the effort of a taxpayer, it will be necessary to judge their income quality not only by Proposition 12, but also by Proposition 14. In its operation Proposition 14 may give an income quality to gains which are a realisation of an increment in value of property itself, and are not within Pitney J.'s formulation of the gains from property principle.

2.232 In general, gains within Proposition 12 will be “passive” gains, in the sense that there will be minimal effort by the taxpayer beyond selection of
an “investment”. But the distinction between passive gains and effort gains, or between unearned income, sometimes called investment income, and earned income, can never be definitively drawn without a degree of arbitrariness. The distinction is drawn in the Assessment Act in the definitions in s. 6 of “income from property” and “income from personal exertion”, the relevance of those definitions being confined to the operation of Div. 7 of Pt III concerned with the undistributed profits tax on private companies. It was drawn at one time for purposes of imposing a higher rate of tax on unearned income.

2.233 The distinction took on significance, at least in the Federal Court, in *Everett* (1978) 78 A.T.C. 4595 ((1980) 143 C.L.R. 440, High Court). Division 6 of Pt III operates in relation to “net income of a trust estate”. There is some authority that “estate” should be equated with “property”, so that Div. 6 may only operate where there is property vested in the trustee from which income is derived. And, presumably, if there is such property, the Division will apply only to the income derived from it and to no other items. The Federal Court judgments wrestle with the question whether income attributable to a share in a partnership is income from a trust estate, or is income from personal exertion. Drawing the distinction between passive gains and effort gains in the context of the phrase “income of a trust estate”, seems especially inappropriate. The words are “of a trust estate” not “from a trust estate”. The use of the words in the drafting of Div. 6 may be thought to have been concerned with ensuring that the calculation is made by reference to an entity distinct from the person who is trustee, and not with restricting the kind of items to which the Division would apply. A view that “trust estate” refers to an entity might be thought to have been confirmed by the definition of a resident trust estate in s. 95 (2) and by other recent drafting, for example the drafting in s. 26AAA(2A) and s. 25A(2) considered in Chapter 3. It is also confirmed by the Federal Court decision in *Totledge* (1982) 82 A.T.C. 4168.

2.234 Gains derived from property include gains to which the words “dividends”, “interest”, “rent” and “royalties” may be appropriate. But the principle may have a wider operation. Reference has already been made to the question not resolved in *Cliffs International Inc.* (1979) 142 C.L.R. 140—whether those who sold the shares, and thus the mine, derived income when they received payments from the buyer calculated by reference to the amount of ore taken from the mine. In addition to the periodical receipts principle (Proposition 11), already discussed, and the compensation receipts principle (Proposition 15), yet to be considered, the gains from property principle may make those receipts income.
Dividends

2.235 The ordinary usage notion of a dividend as an item of income derived from property has been examined in Australian authorities as an aspect of the interpretation of s. 44(1) and s. 47. Section 44(1) gives an income character to a dividend paid to a shareholder in a company, if it is paid out of profits derived by the company. “Dividend” is defined in s. 6 so that it includes, inter alia, any distribution by the company to a shareholder “whether in money or other property”. “Shareholder” includes member or stockholder. Section 47 gives an income character to a distribution by a company in a formal liquidation where the distribution represents income derived by the company. The distribution is deemed to be dividends paid by the company out of profits.

2.236 In the interpretation of s. 44(1) and the definition of dividend in s. 6, the Australian courts have drawn heavily on an assumed notion of a dividend as an item of income by ordinary usage. They have not, however, decided that an item is income for purposes of the Assessment Act simply because it fits this assumed notion.

2.237 Three matters arise for consideration:

(1) what is the ordinary usage notion of a dividend that is income;
(2) what has been the significance of that notion in the interpretation of s. 44(1) and other related sections of the Assessment Act in Subdiv. D of Div. 2 of Pt III; and
(3) is there room for a conclusion that an item is income for the purposes of the Act as a dividend within the notion of a dividend that is income by ordinary usage, even though it is not an item that would be income within Subdiv. D of Div. 2 of Pt III?

The ordinary usage notion of a dividend that is income

2.238 The notion of a dividend that is an item of income by ordinary usage may be inferred from a number of observations made by the High Court in relation to the notion of a dividend that is income under Subdiv. D of Div. 2 of Pt III of the Assessment Act. These observations reflect a fundamental distinction between a receipt in satisfaction of rights which make up the taxpayer's property in a share, and a receipt which is derived from that property. The latter, in the metaphor of Eisner v. Macomber 252 U.S. 189 (1919), is fruit of that property, or in another metaphor, produce of that property, and income. The observations include the following:

“If the . . . company had detached any part of its profits and distributed that part among shareholders, the portion received by each shareholder would have become part of the income of such shareholder”: per Knox C.J., Gavan Duffy and Starke JJ. in Webb (1922) 30 C.L.R. 450 at 461.
“[There will be a dividend if] profits are . . . detached, released or liberated, leaving the share intact as a piece of property”: per Rich, Dixon and McTiernan JJ. in Stevenson (1937) 59 C.L.R. 80 at 99.

“[There must be a] detachment or severance from the funds of the company of money or other assets as representing a profit made by the company. [In the present case] there was simply a realisation of a share investment”: per Fullagar J. in Blakely (1951) 82 C.L.R. 388 at 407.

“[There must be a] distribution of moneys as the produce of shares which should remain nevertheless intact”: per Kitto J. in Uther (1965) 112 C.L.R. 630 at 634.

The notion requires that one examine a distribution, at least primarily, from the point of view of the shareholder to ascertain whether the item is a receipt that comes to him as produce of his shares, as distinct from a receipt that comes to him in satisfaction in whole or in part, of the rights which make up his share. The concept of rights which make up the share presents some difficulty. The right to a dividend, or, more accurately, the expectation of a dividend is part of the rights which make up a share. Yet a dividend once declared is clearly produce. It seems that a receipt is a receipt in satisfaction of a right to dividends, and is not produce, only if it is in extinguishment, in whole or in part, of the right to dividends. Conceivably, a company might make a payment to a shareholder in extinguishment, in whole or in part, of his right to dividends carried by his shares. The right to a return of capital is a right which makes up a share. Uther is authority. A receipt of a payment by which the right to a return of capital is wholly or partly extinguished cannot, it seems, be produce of a share.

2.239 The observations quoted in the preceding paragraph are all concerned with a company that has a share capital. Where a company does not have a share capital, the distinction between produce of a share and a receipt in payment to a shareholder for his shareholding may not admit of a simple rewriting in terms of produce of membership and a payment to a member for his membership. The judgment of Dawson J. in Slater Holdings Ltd (No. 2) (1984) 84 A.T.C. 4883, and the judgment of Gibbs C.J. with which Dawson J. and all the other members of the court agreed, leave the impression that a receipt by a member in winding up may be seen as a payment for his membership, but a receipt while the company is a going-concern cannot be seen in this way. The payment in Slater Holdings (No. 2) had been made to the taxpayer, who was a member, in pursuance of one of the company's articles that provided that the company might make a payment “upon a person ceasing to be a member”. Dawson J. said (at 4890):

“Under s. 47, of course, a distribution by the liquidator in the course of a winding up would be deemed to be a dividend paid to the member by the company out of profits derived by it. But the payment of an amount by the company when the company was clearly not being wound up could not represent a payment for property in the sense that payment to a shareholder of his proportion of the surplus assets of a company might be regarded as payment for his shareholding and the replacement of
one capital asset in his hands with another. No res ceased to exist by reason of payment by the company to the taxpayer in this case.”

The description of the effect of s. 47 is hardly an accurate statement. In any case it is not directly relevant to the question whether a distribution in liquidation is a distribution in satisfaction of the rights of a member and thus not produce. And the observation in regard to a payment when a company is not being wound up may go further than Dawson J. intended. A payment to a member under an article which provided for the making of a payment, and provided that the member would on that payment cease to be a member, may be treated differently from the actual payment in Slater Holdings (No. 2).

2.240 The observations quoted in [2.238] above, involve another element—that the distribution has been made “out of profits”. This element requires that the matter be looked at from the company's point of view, so as to determine the source of the produce of the shares. There is a tendency in some of the observations to assume that produce to the shareholder must necessarily be from profits of the company, perhaps because the company law principle of maintenance of capital will generally demand that it be so. But a notion of a dividend that is income for tax purposes cannot be confined to distributions that involve the company law principle. The notion must be relevant, for example, to an unlimited liability company.

2.241 An ordinary usage notion of a dividend that is income could be imagined that will include in relation to any company, whether or not it has a share capital, an element requiring that a distribution have been made from profits. But the explanation of the observations quoted may be simply an importing into the interpretation of the definition of dividend in the Act elements drawn both from the ordinary usage notion and from the requirement “out of profits” that now appears in s. 44(1).

2.242 Examination in the cases of the scope of the ordinary usage notion of a dividend that is income has been concentrated on distributions that have been expressed to be in reduction of share capital, or have been received by a shareholder in the appropriation of the company's assets in an informal liquidation of the company. Uther (1965) 112 C.L.R. 630 is authority that the ordinary usage requirement that a distribution must be produce of shares was an essential element in the notion of a dividend as defined in the Assessment Act at the time of the decision. If that element was not satisfied there could not be a dividend as defined, even though the distribution could be said to be out of profits. In reaching the conclusion that the distribution in that case was not received as produce of the taxpayer's shares, the majority in the High Court (Taylor and Menzies JJ.) took an extended form approach—an approach explained in [2.420]ff. above. The requirement that the receipt must be produce comes to be explained in a rule of contradistinction: that a receipt which is in
satisfaction of a right to a return of paid-up capital is not produce of a share. The fact that the amount received greatly exceeded the amount by which the shareholder's paid-up capital was reduced, did not allow a conclusion that some at least of what was received was produce of the share.

2.243 Subsequent to *Uther* a new definition of dividend was inserted in s. 6. It may be inferred from the new definition that a return of paid-up capital is a dividend to the extent that the distribution is of an amount that exceeds the amount by which the amount paid-up on the share is reduced. A like provision is included to deal with the case where a share is cancelled or redeemed. To this extent the ordinary usage notion that a distribution to be income must be received as produce has been expurgated from the definition of dividend.

2.244 The other cases in which the ordinary usage notion of a dividend that is income has been examined as an aspect of the definition of a dividend, concern liquidations, more especially informal liquidations. A distribution in formal liquidation is a distribution in satisfaction of the rights that make up a share. It is not produce. If a requirement that the distribution must be out of profits is an element of the ordinary usage notion, it cannot be satisfied, at least if the company law principle that a company ceases to have profits once a liquidation supervenes is regarded as applicable. Section 47 of the Assessment Act has made special provision in regard to formal liquidations which leaves no room for the ordinary usage notion, and denies any significance to the absence of profits, by substituting a requirement that distributions must represent “income”.

2.245 Where the distribution is made in an informal liquidation as in *Blakely* (1951) 82 C.L.R. 388—a simple appropriation of the company's assets by its shareholders or members—it is not so obvious that the notion of produce cannot be satisfied. The High Court in *Blakely* held that no part of the receipts by the shareholders were income as dividends out of profits. On one view of the judgments in that case, the decision rested not on the absence of an element of produce, but on the absence of profits whence the distributions could be made. The company law principle that a company in liquidation does not have profits was extended to the tax law of an informal liquidation.

2.246 An argument that the amendments to the definition of dividend, made to overcome the decision in *Uther*, had written out the ordinary usage notion of produce from the meaning of dividend as defined in s. 6 did not have to be considered in *Slater Holdings (No. 2)* (1984) 84 A.T.C. 4883. The payment having regard to its form, could only be characterised as produce. The definition might now be thought to express the assumption
made by para. (e) of the definition that a distribution in reduction of capital is a dividend, except to the extent that it is a distribution of the amount of capital expressed to be reduced. The exception would be unnecessary if a distribution by way of repayment by the company of moneys paid-up on a share were not otherwise a dividend. If a distribution by way of repayment by the company of moneys paid-up on a share is a dividend apart from the exception, it would appear to follow that a distribution paid to a member in full satisfaction of his rights as member is a dividend.

2.247 Whether bonus shares or the amount appropriated to pay them up are income by the ordinary usage concept of income gave rise to differing opinions in *W. E. Fuller Pty Ltd* (1959) 101 C.L.R. 403. It might be thought that the form of the issue suggests a detachment which is received by the shareholder, transmogrified it is true into more shares, but none the less as the produce of his original shares. In substance, however, there is merely a reframing of the shareholder's interest in the company, and this view has been taken by the United States Supreme Court in *Eisner v. Macomber* 252 U.S. 189 (1919) and by the House of Lords in *I.R.C. v. Blott* [1921] 2 A.C. 171. In *Fuller* all the judges agreed that the bonus shares were not income by the general usage concept. Fullagar and Menzies JJ. however, took the view that the amount of the notional distribution appropriated to pay-up the bonus shares was income by the general usage concept. But they did not have the support of Dixon C.J., whose view was upheld in *Gibb* (1966) 118 C.L.R. 628. The question whether rights or options issued to a shareholder as shareholder are ordinary usage income of the shareholder as income derived from his shares has not been considered in any authority. There might be thought to be a detachment from his shares as produce of his shares, though the notion of reframing of his interest is the more likely characterisation. In any case if a requirement that the distribution should be out of profits is an element of the ordinary usage notion of a dividend that is income, it is hard to see how that requirement could be said to be satisfied.

2.248 A description of the ordinary usage notion of a dividend that is income may now be attempted. One aspect of the notion requires that the distribution received should be produce of a taxpayer's shares or his membership of the company. In the application of this notion the High Court has taken an extended form approach. That approach assumes a rule defining the scope of the notion. The rule would assert that a receipt which is in terms the consideration for the surrender or the extinguishment of rights which make up a share or a membership is not a dividend that is income. A view of the facts that reflects a commercial judgment that the distribution is in part, indeed that it is almost entirely, produce of a share or
membership is irrelevant. Such a view might well have been taken of the facts in *Uther* (1965) 112 C.L.R. 630. If the form of the distribution is not a payment for the surrender or extinguishment of rights which make up a share or membership, it will be held to be produce of the share or membership. If there is no attempt to cast a distribution in any form, a commercial judgment will prevail. This is the effect of *Blakely*, in which the appropriation of the assets of the company by its shareholders was treated as a distribution in extinguishment of rights as shareholders.

2.249 There has been no discussion in the authorities of a further element in the ordinary usage notion of a dividend that is income, which may require that the distribution must be out of profits. Such an element is suggested by the statements quoted in [2.238] above. It may be that a distribution that is in form produce—there is a distribution but no surrender or extinguishment of rights—is not an ordinary usage dividend unless it is, in some sense, out of profits. One possible sense is the accounting notion of a debit to a profit account. Another sense would cover any distribution that is produce if there are profits to support it, whatever be the accounting debit. The law of maintenance of capital would suggest the second sense in the case of a company that is subject to that law. But it would not suggest it where the company is not subject to that law. The company may be an unlimited liability company or an unincorporated association.

The specific provisions of the Assessment Act making dividends income

2.250 Some detail of the specific provisions will have emerged from the discussion in [2.238]-[2.249] above. The detail may be summarised in a number of propositions. A distribution to a shareholder or member that is not in form or in commercial judgment made for the surrender of, or in extinguishment of, rights that make up a share or a membership of a company, and which is made out of profits, is income by the operation of s. 44(1) taken with the definition of dividend. The word “shareholder”, as defined in s. 6, includes a member. An issue of rights or options made to a shareholder as shareholder is presumably not made out of profits and is not income by the operation of s. 44(1).

2.251 A distribution made to a shareholder that is in form or in commercial judgment for the surrender of, or in extinguishment of, rights making up a share may be income by specific provision if the distribution is by way of repayment by the company of moneys paid up on a share. It will be income to the extent that it exceeds the amount repaid by the distribution. The element of “out of profits” required by s. 44(1) is supplied by s. 44(1B).

2.252 A distribution to a shareholder or member that is made in a formal
liquidation of a company will be income to the extent that it represents income derived by the company (s. 47).

2.253 A distribution that is made by a company in an informal liquidation, as in the facts of Blakely (1951) 82 C.L.R. 388, will not be income. This is to assume that the provisions of para. (e) in the definition of a dividend have not written out from the definition the requirement, imported from the concept of a dividend that is income by ordinary usage, that the distribution must be produce of a share or membership. It also assumes that distributions in an informal liquidation are distributions by the company, so that s. 47(2B) has no application. Section 47(2B) is based on a misreading of the decision in Blakely. That decision in fact proceeded on the basis that the appropriations by the shareholders were distributions by the company.

2.254 A distribution made by a company to a shareholder which is debited against a share premium account of the company is not income. “Share premium account” for this purpose has the meaning it is given by the definition in s. 6. There is an exception provided for in subs. (4) of s. 6. Where that exception operates a distribution from the share premium account will be income. The element of “out of profits” is supplied by s. 44 (1B).

2.255 Statements about “distributions” in the above paragraphs are equally applicable to a “crediting” by a company to any of its shareholders or members. It follows that the amounts credited in the notional distributions made in a bonus issue will be income, if the crediting is made out of profits.

2.256 A distribution or crediting must in all cases be made to a shareholder or member if it is to give rise to a dividend that is income under the specific provisions. “Shareholder” has a meaning established by the decision of the High Court in Patcorp Investments Ltd (1976) 140 C.L.R. 247 so that it is confined to a person who is registered as a shareholder or who is entitled against the company to be registered as a shareholder. “Member”, presumably, would be given a parallel meaning.

2.257 A number of differences may be noted between the ordinary usage notion of income applicable to distributions by a company and the distributions that are income by the specific provisions. Thus, a distribution in a formal liquidation may be income by specific provision under s. 47. It is not income within the ordinary usage notion.

2.258 A distribution in a formal reduction of capital may be income by specific provision under para. (e) of the definition of dividend and s. 44(1) and s. 44(1B). It is not income within the ordinary usage notion of income.

2.259 A distribution (in this instance a crediting) in paying up shares issued as bonus shares may be income by specific provision (cf. s. 44(2)). A
bonus issue, it seems, is not in any aspect within the ordinary usage notion.

2.260 A distribution that is received by a taxpayer other than a shareholder or member is not income by specific provision. It may be income within the ordinary usage notion, where it is received by a taxpayer who is beneficially entitled to a share.

2.261 A distribution from share premium account is not income by specific provision, save where subs. (4) of s. 6 applies, where the distribution is debited against an amount standing to the credit of a share premium account as defined in s. 6. Such a distribution may be income within the ordinary usage notion. In this instance a question is raised whether a distribution, to be income by ordinary usage, must be made from profits, and whether a share premium account is a profit account. Slater Holdings Ltd (No. 2) (1984) 84 A.T.C. 4883 may have increased the likelihood that a share premium account is a profit account. It was held that an amount received by a company by way of a gift is a profit for purposes of that word as it is used in s. 44(1) of the Assessment Act.

The continuing scope for the ordinary usage concept of a dividend that is income

2.262 Two situations were noted above where an item would be income if the ordinary usage concept of a dividend that is income could determine income character for the purposes of the Assessment Act. The items would be income though they are not income by the specific provisions of Subdiv. D. The items involve a distribution to a shareholder from a share premium account, and a distribution to a taxpayer who is not a shareholder.

2.263 There may be other illustrations, if the ordinary usage notion of a dividend that is income does not require that the distribution be in some sense out of profits, or if any requirement that the distribution be out of profits is more easily satisfied than the like requirement in regard to a dividend that is income by specific provision of Subdiv. D. Section 44(1B) supplies the element of “out of profits” in some circumstances where Subdiv. D operates. For the rest, the meaning of the words “out of profits” is left in considerable doubt. Kitto J. in Uther (1965) 112 C.L.R. 630 was prepared to take the view that the words were satisfied, though the distribution did not fit any form that might be thought to be required by the words. In Uther the debit in the making of the distribution had been made to “a capital realisation account” which, in effect, amounted to the company standing mute as to the source, within company funds, of the distribution. An extended form approach might adopt an interpretation of the phrase “out of profits” suggested by para. (f) of the definition of “dividend” in s. 6, so that it would require a debit to a profit account. In
which event standing mute would exclude a distribution being income under Subdiv. D. There is a suggestion in the judgment of Gibbs C.J. in *Slater Holdings (No. 2)* (1984) 84 A.T.C. 4883 that a payment will not be held to be out of profits unless it is made wholly out of profits. Gibbs C.J. said (at 4888):

“...what appears to be implicit in the judgment of Taylor J. in *F.C.T. v. Uther* is the suggestion that to come within s. 44(1)(a) the distribution must have been made wholly out of profits; it is not enough that there is a distribution of a mass of assets which contains profits. This view may be supported by the fact that the section does not refer to ‘dividends to the extent to which they were paid to him by the company out of profits’, since, in the light of the construction given to s. 51 of the Act, the inclusion of the phrase ‘to the extent to which’ would no doubt have allowed a dissection or apportionment to be made of the distribution. . . .”

The suggestion by Gibbs C.J. invites action by an unlimited liability company to make a distribution expressed to be partly from share capital and partly from revenue profits, and to refrain from any immediate accounting entries that would show debits to the relevant accounts.

2.264 Whether the ordinary usage notion of a dividend does in any circumstances give an income character, for purposes of the Act, to a distribution will depend on the answers that are given to the question whether Subdiv. D is a code, and as to the field of that code. All the provisions of Subdiv. D, other than s. 45, relate to distributions to a shareholder or member, and a possible field for any code would be distributions to shareholders and members. Another possible field would be broader: it would extend to all distributions by a company.

2.265 There is no case in which Subdiv. D has been held to be a code covering the field of distributions to shareholders and members. There is one authority in which the assumption appears to be that it is not such a code. Reference has been made to *W. E. Fuller Pty Ltd* (1959) 101 C.L.R. 403. The discussion in that case of the question whether a bonus issue is in any respect within the ordinary usage notion of income proceeds on the assumption that it could, in the relevant respect, be income for purposes of the Assessment Act, though the effect of s. 44(2) might be to make it exempt income.

2.266 In all recent decisions the question whether an item would be within the ordinary usage notion of income has been raised in the interpretation of the provisions of Subdiv. D. A conclusion that the item was not within the ordinary usage notion became a conclusion that it was not income by force of the Subdivision. There is no inference to be drawn that if the item had been within the ordinary usage notion, it could have been income for purposes of the Act, otherwise than by the operation of Subdiv. D. It is,
however, unlikely that a court would find that a distribution from share premium account is income for purposes of the Assessment Act as an item of income in ordinary usage, where it is expressly excluded from the distributions that are made income by Subdiv. D. The approach of the majority in Reseck (1975) 133 C.L.R. 45, an approach which in the present context would make Subdiv. D a code, is the more likely. It might be thought equally unlikely than an item will be held income for purposes of the Act if it satisfies a more flexible notion of “out of profits” than the notion which will satisfy Subdiv. D. All these observations are made without regard to the words added to s. 25(1) in 1984. While those words remain in s. 25(1), they carry a near inescapable inference that Subdiv. D cannot be a code covering the field of distributions to shareholders. The effect of those amendments is discussed at [2.223] above and [2.369] below.

2.267 There is authority from which it may be inferred that Subdiv. D is not a code in relation to a distribution to a taxpayer who is not a shareholder. It was not questioned in Angus (1961) 105 C.L.R. 489 that the taxpayer had derived income in the receipt of a distribution by a company which the trustee for him, who was the shareholder, had directed the company to pay to him. There was a receipt by the taxpayer under the ordinary usage concept of income as produce of the beneficial interest in the shares which he had as life-tenant.

2.268 The taxpayer, on the law as it stood at the time of Angus, was entitled, under s. 23(q), to exemption from tax on the distribution: the distribution had a foreign source and was taxed in the country of source. Subsequent to Angus, s. 23(q) was amended so that it now has no application to “income . . . attributable to a dividend”—defined in s. 6B in a way that will include the receipt by a person in the situation of Angus. And s. 45 was amended so as to allow a credit for foreign tax on income attributable to a dividend. As it was previously framed, s. 45 allowed a credit only in respect of a dividend as defined in s. 6, which is confined to a distribution made to a shareholder.

2.269 At the time Angus was decided the trust provisions in Div. 6 of Pt III had no application to foreign source income derived by the trustee of a trust estate. The changes made to Div. 6 in 1979 make the Division applicable to a distribution of the kind made in Angus. It would now be income derived by the trust entity by virtue of derivation by the trustee shareholder. It would be income by the operation of s. 95 and the deeming of the trustee to be a taxpayer, combined with the operation of Subdiv. D, without any operation of the ordinary usage notion of a dividend that is income. The lifetenant would derive income under s. 97 of Div. 6. He
would be entitled to a credit for the foreign tax under s. 45.

**Interest**

2.270 Any item expressly described in an agreement, or order of court, as “interest” will be within the gains from property principle, unless the description is contradicted by the terms and circumstances of the agreement or order under which it is payable. The contradiction in the terms and circumstances will need to show that the item is not within the substance of the gains from property principle. The metaphors of fruit and tree and of land and produce by which the principle is described are limited in their usefulness as expressions of that substance. The substance is perhaps better expressed as a payment received for the use of one's property by another, as distinct from a payment received for the partial giving-up of one's property to another. The distinction between a return for allowing use by another and a receipt for the partial giving-up of property is reflected in a distinction between “interest” properly used to identify gains from property, and a “premium” reflecting a receipt from a partial realisation of property itself. The distinction here suggested as a means of isolating the substance of the gains derived from property principle, may be thought to exist only in words. It is, however, a kind of distinction that is ubiquitous in income tax law. A related distinction is drawn in identifying, for purposes of Proposition 14, a gain which arises from the carrying on of a business. Such a gain is to be distinguished from a receipt which arises from the realisation of a part of the business itself. If distinctions of this kind do not reflect substance, a great deal of judicial discussion which assumes that they do can only be regarded as futile.

2.271 The substance of the principle concerns the function of the payment, which is primarily at least a matter of objective inference. Receipts in a series are more likely to be regarded as gains from property than a single receipt, more especially when they are payable only while the use by another continues. A single receipt which is not subject to adjustment if the use by another does not continue for the intended time, is more likely to be regarded as a receipt for the giving up of one's property to another.

2.272 In the case of interest, the relevant property is money—money lent, or money otherwise the subject of a debt. The distinction between a payment received for the use of one's property by another and a payment received for the partial giving-up of one's property to another, will be thought irrelevant if strict notions of property and alienation of property are applied. Money lent becomes the property of the borrower, and it will be said that the interest he pays cannot be regarded as being for the use of that
property. Principles of tax law are almost inevitably framed in language which attracts the possible application of principles belonging to some other area of law. The interpretation of principles of tax law in this manner is unacceptable, more especially when the principle is no more than an attempt to formulate the ordinary usage notion of income. Where a receipt is for the use of one's money by another, the notion of one's money being understood in a way that transcends strict notions of property, it may be described as interest as a term of tax law identifying one kind of gain derived from property and income in that character.

2.273 Just as the express description of an item as interest in any agreement will prima facie put it within the gains from property principle, an express description of an item as a premium will prima facie put it outside that principle. The latter description may, however, be contradicted by the terms and circumstances of the transaction. The relevance of circumstances calls for a wider inquiry in the application of the substance of the gains from property principle than that thought appropriate in relation to the application of s. 51(1). In this respect, the interpretation of s. 51(1) has undergone an unacceptable development. That interpretation is considered in [9.17]ff. below. To confine the inquiry to legal relations which arise in a transaction, which is the tendency in relation to s. 51(1), is to invite action to defeat what policy there may be in the principle applied. Thus an amount payable under an agreement may, if the terms of the agreement are alone considered, be a premium in a tax law sense that will put it outside the gains from property principle. But regard to the circumstances—more especially the circumstance that a less than commercial rate of interest is reserved by the agreement—may contradict that conclusion. The matter is considered in [2.285]-[2.289] below.

Instalment receipts of a debt or of the sale price of property

2.274 In all of Foley v. Fletcher (1853) 3 H. & N. 769; 157 E.R. 678, Secretary of State in Council of India v. Scoble [1903] A.C. 299, Vestey v. I.R.C. [1962] Ch. 861 and Lord Howard de Walden v. Beck (1940) 23 T.C. 384, considered in relation to Proposition 11, the payments were treated as instalment receipts of a debt or sale price of property, and not as periodical receipts. In all but the earliest of them—Foley—it was either conceded (Scoble) or held (Vestey and Lord Howard de Walden) that a part of each instalment represented interest on the debt or sale price, and was income. No interest had been expressly provided for in the terms of the relevant transaction.

2.275 In Foley the only question raised was whether the whole of each
payment was income in the hands of the seller as a payment that was one of a series of periodical receipts. The court was not asked to consider “whether income tax might be payable in respect of such part of each instalment as consists of interest” (3 H. & N. at 788, per Channell B.).

2.276 In *Foley* there was no express provision for payment of interest on the sale price, though there was a provision for payment of interest on an overdue instalment. The case was tried on demurrer, and there was nothing in the record to show that in fact the land sold by the plaintiff was worth less than the sale price. In *Vestey*, Cross J. refused to accept statements by Pollock C.B. and Bramwell B. in *Foley* that even if it had been proved or admitted that the plaintiff’s land had been worth far less at the time of sale than the sale price, it would not have been proper to treat as income an interest element in each instalment receipt.

2.277 *Vestey* was concerned with a sale of shares for an annual sum of £44,000 over 125 years—a total payment of £5,500,000. The total payment controlled the payment by instalments: there was provision that on default in payment of any one instalment, the balance of all the instalments would immediately become due and payable. There was evidence that the accountants advising the father of the vendor had put a value on the shares of £2,000,000, on the basis of a sale under which the sale price would be payable immediately. There was, however, no evidence that the vendor was aware of this advice. Cross J. affirmed the decision of the special commissioners ([1962] Ch. 861 at 867) that the annual payments (other than the first which was payable on transfer of the shares) contained an interest element “to be calculated upon the method laid down in... Scoble”, the figures to be agreed in accordance with the decision. The fact that the balance of instalments, including the interest element in those instalments, would become payable on default in payment of any instalment was held not to preclude the separating out of interest. The payment of interest in these circumstances was to be explained as a penalty.

2.278 *Scoble*, in which it was conceded that separating out an interest element was proper, differs from *Vestey* in that the *Scoble* agreement provided for options available to the buyer. He might pay the value of the shares in one sum, the value to be ascertained in accordance with the agreement. Or he might pay for the shares by a series of payments over 99 years, “the interest to be used in calculating [the series of payments] being determined by the average rate of interest during the preceding two years received in London upon public obligations of the East India Company”. The buyer had exercised the latter option. The agreement in the circumstances of the option exercised thus required the determination of
the value of the shares and specified an interest rate to be used in calculating the amounts of the series of payments. It may be assumed that the interest rate applied in *Vestey* was that used by the accountants advising the seller's father in calculating the amounts of the payments in a series—the rate that would give a present value of £2,000,000. Neither that rate, nor the value of the shares from which it might be calculated, was to be found in the agreement.

2.279 The method of separating out the interest element in each instalment followed in *Scoble* involved treating each instalment as a payment of interest on the amount of the value of the shares remaining outstanding at the time of payment, and as to the remainder a payment of part of the value outstanding. In *Lord Howard de Walden* the taxpayer argued for a different method. The case concerned the purchase, from the maker, of a series of promissory notes. The consideration given by the taxpayer for one set of notes was a cash payment. The consideration for another set was a cash payment and the release of certain obligations to the taxpayer owed by the maker of the notes. The taxpayer argued that any interest element should be determined in relation to each note, so that the interest element in early receipts would be less than in later receipts. Wrottesley J. held that in the absence of any agreement between the parties, either at the time when the agreement was made or at the time of his decision, the *Scoble* method should prevail. He observed that he would have been willing to approve another system, had it been put before him, a system “which results in interest and capital being distributed over each payment practically in the same proportion” ((1940) 23 T.C. 384 at 401).

2.280 In *Lord Howard de Walden* there was some evidence of the value of the obligations owed to the taxpayer which were released as part consideration for some of the notes. That value was used in calculating that the promissory notes included an interest element of 4 per cent on the consideration given for the notes. The case supports *Vestey* in the use of evidence of value in this way, though the judgment of Wrottesley J. rather begs the question in the manner in which he dismissed a submission by the taxpayer that evidence of value could not be used. The release of obligations, he said (at 400), was not a circumstance which affected his decision “provided that the element of interest can still be segregated”.

2.281 In *Foley* it was assumed that the agreement was a sale for an amount to be paid by instalments without interest. The separating out of an interest element would have contradicted the words of the agreement. Such a contradiction was in fact involved in the decision in *Vestey*. In *Lord Howard de Walden* there might appear to have been a contradiction, so far as the terms of the promissory notes were concerned. But the agreement as
a whole involved on its facts, at least in relation to the promissory notes purchased entirely for cash, payments in excess of the consideration given. The agreement thus took the form of an outlay of $X for a series of receipts amounting to $X + Y, and the $Y, whether or not called interest, appear as a gain derived from property. The distinction between interest on each of the promissory notes and interest on the transaction as a whole, would have been important if the promissory notes had been negotiated to a third party, and the Revenue had sought to find an interest element in the receipt of the amount of the notes by the person to whom they had been negotiated. The receipt by him might have included an element of profit on the transaction of purchase and receipt of payment, but it would not, it seems, have included a gain within the gains from property principle. The matter is further considered in [2.292]-[2.296], [6.308]ff. and [12.183]ff. below.

2.282 There is a question as to the kind of evidence of value that will bring a case within Vestey and Lord Howard de Walden. The suggestion in Lord Howard de Walden is that it must be evidence of the amount some person, who may be the actual buyer, would have paid in cash immediately. Wrottesley J. said (at 398), referring to I.R.C. v. Ramsay (1935) 20 T.C. 79:

“A dentist desirous of selling his practice may know that purchasers for cash down are not to be found at all, and may arrive at the terms at which he will sell, not along the lines of cash down at all, knowing that his only chance of obtaining a good price is by accepting it in instalments. . . . The difficulty of assessment may well account for the fact that hitherto no claim has been made in respect of that part of a purchase price which takes care of the delay attending its payment. I am not going to say that such a sum, if ascertainable, is not interest. It would depend on the facts of the case.”

The suggestion is that there is not necessarily income derived from property simply because a creditor waits for his money. It must be evident that he could have had an amount earlier, but preferred to wait for a greater amount. The difficulty with such a rule is that there will always be some amount the creditor could have had earlier, though it might have been an unacceptably low amount. There is need, none the less, for some reconciliation with a view that a creditor is not obliged to charge interest. The reconciliation can only be achieved by asking whether the substance of the gains from property principle is satisfied. Is it to be inferred, at least objectively, from the terms and circumstances of the transaction that the creditor accepted delay in return for a greater receipt?

2.283 In none of Scoble, Vestey and Lord Howard de Walden is there any discussion of the possible application of a principle, considered below in [2.285]ff. in relation to the repayment of a loan, which would treat an amount received in excess of the money lent as a receipt to cover the risk of loss of his capital which the lender takes when making a loan. Attracting that principle may be assisted by the description of the amount as a “premium”, though the description will not necessarily prevail. It would be
consistent with that principle, in a Scoble, Vestey or Lord Howard de Walden situation where the interest element that would otherwise be separated out is more than a commercial rate, to treat some part of that element as being for the capital risk and thus not a gain derived from property. The receipt is not in respect of the use of money by another, but for the partial giving up of one's property to that other.

2.284 There is no Australian case like Scoble, Vestey or Lord Howard de Walden in which an interest element has been separated out and brought to tax. Were it not for s. 262 of the Assessment Act, McLaurin (1961) 104 C.L.R. 381 and Allsop (1965) 113 C.L.R. 341, considered below in relation to Proposition 15, might have precluded such separation. Section 262 would appear to be applicable in Scoble and Vestey situations, and to empower the Commissioner to separate out and tax an interest element. The application of the section in a Lord Howard de Walden situation may be doubtful. The payments may not be within the words of the section: “payment[s] for the assignment, conveyance, transfer or disposal of . . . property.”

Payments where money has been borrowed

2.285 Where money is lent and a debt is acknowledged by the borrower of a greater amount than the amount of the moneys lent so that the borrower may be said to have allowed a discount, or the moneys lent are repayable at a premium, some or all of the discount or premium may, according to United Kingdom authorities, be income and subject to tax. The leading cases are I.R.C. v. Thomas Nelson & Sons Ltd (1938) 22 T.C. 175 and Lomax v. Peter Dixon & Son Ltd [1943] 1 K.B. 671. Where a reasonable commercial rate of interest is not reserved, some or all of the discount or premium may properly be regarded as interest and income subject to tax. The true nature of the discount or premium must be ascertained from all the circumstances. It will not be regarded as interest where it is in respect of the risk of capital depreciation which the lender takes in making the loan. It will be relevant to consider whether the parties have expressly stipulated that the discount or premium is in respect of the risk of capital depreciation, and the measure of that risk which may arise from the length of the period of the loan, political or international circumstances affecting the loan, the instability and prospect of inflation of the currency in which it is payable, and the prospect of depreciation of that currency in relation to the currency from which the loan has been made.

2.286 There is a question whether any part of an amount described as interest may be regarded as being for the capital risk, and thus not income
under the gains from property principle. It is agreed that the description may be contradicted by the terms and circumstances of the transaction under which the amount is payable. Where, however, the amount is one of a series of amounts payable only while the loan is outstanding, or where it is a single amount that will abate in part if the loan is repaid before the agreed date for repayment, it is likely that the whole of the amount is a gain from property. Tax law does not control the amount of a gain that may be derived from property, and the fact that the amount reflects a rate of interest beyond a commercial rate is unlikely in itself to be sufficient to show that in substance part of it is for the capital risk.

2.287 None the less, if the terms and the circumstances of the lending are considered, there may be grounds for saying that some part of the interest rate fixed by the terms of the loan was intended to cover the anticipated fall in the value of money during the period of the loan. The agreement for a loan may have referred to a rate of interest to be determined by the addition to a specified rate, of a further rate reflecting the rate of inflation at the time of the agreement. The United Kingdom authorities indicate that these circumstances will not displace the character as interest which follows from the description as interest. The parties, it is said, have chosen to express the payment for the capital risk as interest. The reason may be thought simply to beg the question.

2.288 It is sometimes suggested that the principle by which a receipt for the capital risk experienced by the lender in conditions of inflation will be outside the gains from property principle, offers a general basis for denying tax consequences to unreal gains. But it is a most inadequate basis, because it stops short of challenging the assumption of stable money values upon which the income tax is built. An adequate basis will involve expressing all items in the returns of all taxpayers in terms of the current purchasing power of money. Principles might then be developed on this basis. Short of this, any new principles or new provisions of the Assessment Act will be only palliatives. The Taxation Review Committee's Full Report (A.G.P.S., Canberra, 1975, para. 9.80) suggested, as a palliative, a new provision in the Assessment Act which would allow a limited deduction against interest income. This would make some contribution to correcting the taxation of the unreal gains, which arise in times of inflation when the return on money lent is wholly expressed as interest. The matter is further considered in Chapter 15.

2.289 There is no Australian case in which a discount given or premium received has been separated into elements of gain derived from property and receipt for capital risk. The decisions in McLaurin (1961) 104 C.L.R. 381 and Allsop (1965) 113 C.L.R. 341 may stand in the way, and s. 262, in
these circumstances, may not authorise the separation. It should be noted that the Taxation Review Committee recommended that the Act be amended to displace the McLaurin and Allsop decisions: Full Report, para. 7.101.

**Periodical receipts**

2.290 The conclusion reached in [2.209]-[2.210] above is that receipts which are within the periodical receipts principle are income in the whole of their amounts. Any separation out of an interest element requires the operation of s. 27H.

2.291 In *I.R.C. v. Land Securities Investment Trust* [1969] 1 W.L.R. 604 payments were made that were held in *I.R.C. v. Church Commissioners* [1977] A.C. 329 to be periodical receipts of the receiver. The payments in *Land Securities* were held not deductible, though the Crown agreed to allow as an expense the “interest content” of the payments. The manner in which such an interest content might be separated out, and the basis in principle, are not evident. The matter is considered in [2.210] above.

**The proceeds of redemption or sale of a debt acquired at a discount**

2.292 A taxpayer acquires a security—in this context a debenture—evidencing or acknowledging the indebtedness of another person. The obvious illustration is a Government issued bond. He pays an amount which involves a discount on the amount of the indebtedness. A discount is appropriate because the rate of interest on the indebtedness is low when compared with current rates of interest. Thereafter he receives the amount of the indebtedness when the security is redeemed, or he sells the security for an amount greater than he paid for it. It may be asked whether any part of the amount received on redemption or sale of the security is income as a gain derived from property.

2.293 It would be argued that there is no income derived from property, though, to the extent that the amount received is greater than the amount paid, there is a profit that might be income of a person whose business includes buying and selling securities, or of a person who carries on a business to which buying and selling securities is incidental. Indeed that person might have acquired a security as trading stock, and the trading stock provisions will apply to give an income character to the whole receipt, while allowing a deduction for the cost of the security. The relevant principle is Proposition 14 applicable to gains in carrying on a business. And the profit might be income, in the circumstances of a sale of the security, by virtue of s. 25A(1) (formerly s. 26(a)) or s. 26AAA,
considered in Chapter 3.

2.294 The possibility that the profit is a gain derived from property, so that it may be income in the hands of a person who is not engaged in business operations, and does not act in a way that will bring s. 25A(1) or s. 26AAA into operation, cannot be excluded. Where the security has been originally issued to the taxpayer at a discount and he holds until redemption, principles considered in [2.285]-[2.289] above will be attracted. But there are analytical problems in treating the profit as income derived from property when the taxpayer has acquired a security already issued, more especially if he has sold the security as distinct from receiving payment on redemption. The proceeds of sale appear to be proceeds of realisation of the property itself. And there are tax accounting problems considered in Chapter 12 ([12.183]ff. below).

2.295 None the less, s. 23J of the Assessment Act assumes that the profit is income, presumably as a gain derived from property. Section 23J provides that no part of an amount received by a person upon the sale or redemption of a security of the kind now considered, acquired on or before 30 June 1982, shall be taken to be income derived by the person. There is an exception of any part of the amount received as accrued interest. The section goes on to provide that it has no application to a transaction that is part of or is incidental to, the carrying on of a business that includes buying and selling securities of any kind, and that the section does not operate to deny an income character that arises from the operation of s. 25A(1) (formerly s. 26(a)), s. 26AAA or s. 26C.

2.296 Section 23J was enacted subsequent to a statement by the Commissioner made prior to 30 June 1982, that the profit in the circumstances with which the section deals was income as a receipt “in the nature of interest”. The purpose of the section was to give immunity to persons who had acquired securities on or before 30 June 1982 which would include persons who had acquired before the Commissioner's statement. It may be asked whether the assumption that lies behind the giving of an exemption is thereby made law.

Rent

2.297 The distinctions drawn, and the issues raised, under the last heading in relation to “interest” in respect of allowing the use of money by another and “premium” in respect of the capital risk in giving up one's property to another, have their parallels in relation to “rent” and “premium” (or “fine” or “foregift”) in respect of a lease of land or chattels.

2.298 A receipt described as “rent” will ordinarily be within the gains
derived from property principle. The word will identify a receipt for allowing the use by another of one's property. The possibility that a receipt described as rent may be outside the principle is remote, but ought not to be excluded. If the receipt is a single sum and does not abate if there is a termination of the lease before the agreed date, the terms of the lease will go some way to contradicting the description. If, in addition, the lease provides for other payments, whether or not they are also described as rent, which are within the gains from property principle, the contradiction may be complete.

2.299 A receipt described as a “premium”, “fine” or “foregift”—terms ordinarily used to identify receipts for giving up one's property to another—may none the less be within the gains from property principle. An amount described as a premium payable in a series of amounts, which will cease if there is a termination before the agreed date, more especially if there is no provision for other payments which are gains from property, stands to be treated as a gain from property.

2.300 The distinction between what is in substance rent—a receipt for allowing the use by another for one's property—and what is in substance premium—a receipt for giving one's property to another—is even more difficult to define than the distinction between interest and premium. There are hazards in losing control of one's money by lending it, which are not matched by the hazards of losing control of one's land, or perhaps a chattel, by leasing it. What is in substance a premium may in the latter context be so much the more difficult to identify. Where substance is difficult to identify, words of description are the more likely to prevail. Difficulty in identifying what is in substance a premium may explain the differing conclusions of the Australian Royal Commission on Taxation (Third Report, 1934, Section XL) and of the Final Report of the United Kingdom Royal Commission on the Taxation of Profits and Income (Cmd. 9474, 1955, p. 259). The former considered that premiums were within the gains from property principle. The latter thought they were not.

2.301 Where an amount that is in substance rent has been received by a lessor, and that amount is less than a commercial rent, there is some basis for questioning whether the whole of another amount received by the lessor and described as a premium is a premium in substance. Lomax v. Peter Dixon & Son Ltd [1943] K.B. 671 may suggest that in these circumstances part of the amount described as a premium should be separated out and treated as gain derived from property. McLaurin (1961) 104 C.L.R. 381 and Allsop (1965) 113 C.L.R. 341 may be a barrier to this separating out, unless the Commissioner can call on s. 262. In this regard, it may be argued that a lease is not an “assignment, conveyance, transfer or disposal
of the property”, though “transfer” would appear to be a word of wide meaning. And s. 262 will only be available where the amount described as a premium is payable by “periodical payments”.

Section 26AB

2.302 The Assessment Act contains two sets of provisions relating to “premiums” in respect of leases of property. These are Div. 4 of Pt III, inserted in the Act following recommendations by the 1934 Royal Commission, and s. 26AB. Div. 4 of Pt III is applicable only to leases granted on or before 22 October 1964, and its application to such leases is limited in ways specified in s. 83AA. The discontinuance of Div. 4 in 1964 followed criticisms of its operation made in 1961 by the Ligertwood Committee (Report of the Commonwealth Committee on Taxation, Ch. 6). Section 26AB applies to all premiums as defined in the section, with the exceptions specified in s. 26AB(5). Among these exceptions is a premium in relation to which Div. 4 applies.

2.303 Division 4 in s. 84 makes a premium, as defined, income, and makes special provision as to the manner in which the premium is brought to tax. The definition of premium in the Division (s. 83), is substantially the same as in the more recent provisions of s. 26AB.

2.304 The definition of premium in s. 26AB(1) is:

“In this section, ‘premium’ means a consideration payable in one amount, or each amount of a consideration payable in more than one amount, where the consideration is—

(a) in the nature of a premium, fine or foregift payable for or in connexion with the grant or assignment of a lease; or
(b) for or in connexion with an assent to the grant or assignment of a lease, but does not include an amount in respect of goodwill or a licence.”

Section 26AB(2) gives the character of income to a premium received by a taxpayer where the property the subject of the lease was not, at the date of the agreement to grant or assign the lease or the date of assent to the grant or assignment, intended by the grantee or assignee to be used by the grantee or assignee or some other person for the purpose of gaining or producing assessable income. Where some use for the purpose of gaining or producing assessable income and some use for other purposes is intended, such part of the premium will be income as the Commissioner considers may reasonably be attributed to the intended use of the property for those other purposes (s. 26AB(3)). The section makes the character as
income depend on the intention, in regard to the use of the property, of a person other than the taxpayer. Section 26AB(4) allows the Commissioner to apply the section on the basis that an intention to use for the purpose of producing assessable income existed, if the taxpayer satisfies him that at the relevant time he believed on reasonable grounds that such an intention existed.

2.305 The theory of s. 26AB is that a person who pays a premium in respect of the lease of property he intends to use for the purpose of producing assessable income, will not be entitled to a deduction under s. 51. He would have been entitled to a deduction had he paid rent. In the circumstances it is appropriate that the person receiving the premium should not be treated as receiving income. A person who makes a payment in respect of the lease of property that he does not intend to use for the purpose of producing assessable income, will not be entitled to a deduction whether the payment is in the form of a premium or rent. In these circumstances it is appropriate that the person receiving the premium should be treated as receiving income. Otherwise the receipt of a premium rather than rent would become a method of tax planning.

2.306 The theory of the section, as so explained, makes two assumptions:

(i) that the payment of a premium in respect of the lease of property intended to be used for the purpose of producing assessable income will not be deductible; and
(ii) that a premium received will not be income by ordinary usage, whatever the use of the property intended by the person paying the premium.

2.307 In the House of Lords decision in Strick v. Regent Oil Co. Ltd [1966] A.C. 295 discussed in Chapter 6 below, the payment of a premium in respect of property intended to be used for the purpose of producing income was held not to be a deductible expense. But the case is not authority that the payment of a premium in such circumstances can never be a deductible expense. The second assumption—that a premium received cannot be income by ordinary usage—is not supported by the discussion in [2.297]-[2.308] above of the gains from property principle. A receipt called a premium may be income where it is within the substance of the gains from property principle. And a receipt called a premium which is a premium in substance, and is thus not within the gains from property principle, may be income under Proposition 14 as a gain in carrying on a business. A person who deals in land who takes a premium on the grant of a lease derives income from a partial realisation of rights in land in which he deals: Kosciusko Thredbo Pty Ltd (1984) 84 A.T.C. 4043 at 4052, per Rogers J.
2.308 The assumptions that may explain s. 26AB are not made law by s. 26AB. Deductibility of a premium paid continues to depend on the operation of s. 51, and a premium which is not income by force of s. 26AB may yet be income as a gain derived from property, or may include income as a gain from carrying on a business.

Royalties

2.309 Receipts which are royalties in the narrow meaning Australian courts have given to the word, and other receipts which might be covered by a more extended meaning of the word, may be within the gains from property principle. In this context, as in the contexts of interest and rent, identifying the substance of the principle must rest on a distinction between receipts for property, and receipts for the use of property.

2.310 The present concern is whether receipts are income in ordinary usage and not whether they fit within some meaning of the word “royalties”. The Assessment Act includes a definition of royalties in s. 6. The definition is relevant to the operation of s. 6C, s. 26(f), s. 124J, s. 256 and some other sections. The definition is an “includes” definition and may in any case be displaced by the context. It is partially displaced in the terms of s. 26(f), considered in [4.114]-[4.120] below. In the result it becomes necessary to identify the meaning that the word royalties carries unaided by the definition in order to determine the effect of s. 26(f) in making items, described as royalties, income. It is necessary to identify the meaning the word carries unaided by the definition in order to determine the effect of other provisions, the most important being s. 6C (in relation to giving income a source in Australia), which attracts the definition, but extends also to items which are within the unaided meaning. Reference is made in what follows to a number of decisions on the meaning of royalties unaigned by the definition.

2.311 Some of the receipts considered in the survey that follows will be income under Proposition 14—gains in carrying on business—whether or not they are within the gains from property principle. Thus a single amount received for the supply of know-how, unaccompanied by any associated withdrawal from business in the area in which the know-how will be used, may be income as a gain from a business activity of selling know-how. A single amount received in these circumstances was held to be income in *Rolls-Royce v. Jeffrey* [1962] 1 W.L.R. 425. Such a receipt may not be income as a gain derived from property. But one of a series of amounts, each amount becoming payable because of the use of know-how supplied in the like circumstances, may be income both as a gain from a business
activity of selling know-how and as a gain from property. The gains in *White* (1968) 120 C.L.R. 191, involving dispositions of timber effected by the method in *Stanton* (1955) 92 C.L.R. 630 ([2.315] below), were income as gains from carrying on business, though they may not have been gains derived from property. Had the dispositions been effected by the method in *McCaulay* (1944) 69 C.L.R. 235 ([2.314] below) the gains would presumably have been income as gains from carrying on business and as gains derived from property.

2.312 The observation in the last paragraph that an item may be income both as a gain derived from property and as a business gain may appear to assume that on either basis the amount of the gain will be the same. That assumption will be correct if the gain derived from property is pure gain, so that it is not in any part referable to the realisation of the property. So far as the gains from property principle will characterise as gain a receipt which is in part referable to the realisation of property, the principle may give an income quality to a greater amount than the business gain principle. The latter, it will be submitted, gives an income quality only to the profit element in the receipt. In some circumstances, the gains from property principle may treat as a gain an element in a receipt which is proceeds of realisation of the property. So far as the principle operates in this way, there is a conflict with the principle that gain is an essential quality of income. The conflict is of the kind that arises in the operation of Proposition 11 when an annuity is purchased. In some circumstances the defeat of the principle that gain is an essential quality of income is mitigated by specific provisions allowing amortisation deductions. These are s. 124J, in relation to timber, and Div. 10B of Pt III in relation to commercial and industrial property. Section 124J will allow such deductions when the receipts are as or by way of royalties, within the meaning given to that word in judicial decisions, and any extended meaning that may arise from the definition of the word in s. 6. The scope of s. 124J is considered in [6.184], [6.198], [6.199], [7.19] and [7.28] below. Division 10B allows deductions in respect of expenditure of a capital nature, by the owner, on items of commercial or industrial property which are used by him to produce assessable income. There may be no operation of the Division in the contexts now considered. The scope of Div. 10B is considered in [10.235]ff. below, where it is suggested that the Division only applies where there is a direct use by the owner of the item of property. It does not operate where he licences another to use the item of property.

Receipts in respect of rights inherent in the ownership of land, or other rights in
It is necessary to draw distinctions which may assist in defining the operation of the gains from property principle. It is not intended to adopt technical distinctions which may be drawn in the law of real property, though the latter may be in parallel. Where possession of the land is retained by the taxpayer

The receipts may be in a series, each payment being the consequence of acts by another which would infringe the taxpayer's rights if he had not given his consent. “Consequence” may be too broad a term. The payments to which reference is intended are, in effect, triggered by the acts of the other. The payments in McCauley (1944) 69 C.L.R. 235 are an example. The taxpayer by the agreement in that case consented to another entering and taking timber from his land. The payments were due under the agreement as timber was taken, and the amount of each payment was determined by the amount of timber that had been taken. The decision in the case was that the receipts were income under s. 26(f) because they had been received “as or by way of royalty”. The case is thus authority on the meaning of the word “royalty” as it is used in the Assessment Act, and not on the scope of the gains from property principle.

The receipts in McCauley admit of the description that they are “for the use” of property and for this reason may be within the gains from property principle, though the distinction between McCauley and Stanton (1955) 92 C.L.R. 630, borders on the verbal. In Stanton, where the payments were for timber which the purchaser was allowed to enter and take, the payments not being triggered by the taking, the conclusion was that the receipts were not “as or by way of royalty” under s. 26(f). The case does not in terms decide that the receipts were not income by ordinary usage.

Timber is a renewing resource and the notion of a gain derived from property might be thought applicable whether or not the payments are triggered by the taking of the timber. White (1968) 120 C.L.R. 191 is authority that the renewing resource aspect is relevant to a conclusion that the taxpayer is engaged in a business of growing and selling timber, so that receipts for timber will be income under Proposition 14. The case did not consider the question whether the receipts were income under the gains from property principle. It seems to have been assumed that Stanton precluded any conclusion that the gains from property principle applied.

The scope of the gains from property principle, in its assumed application in the McCauley facts, may be tested by posing the question whether receipts, under a McCauley type agreement which relates to the
taking of sand and blue metal, would be income derived from property. The question is of course obscured in the operation of the Assessment Act by the assumption, founded on observations in McCauley, that such receipts would be royalties and income under s. 26(f). The question might also be posed in relation to the taking of other minerals to which a taxpayer as owner of land has title, or the taking of minerals to which the taxpayer has the mining rights. In all these cases what is taken is not a renewing resource, and, whatever the form of the transaction, the taxpayer has in fact disposed of some of his permanent physical property or rights to permanent physical property. The notion of realisation of a gain derived from property may be thought inapplicable. The gain, if any, should be the profit realised by the disposal of the property, and that gain will be income by ordinary usage only where the disposal is in the carrying on of a business.

2.318 An agreement concerned with a non-renewing resource may be in the Stanton form with the difference that the payment for what is taken is in more than one amount. In fact in Stanton there were instalment payments of a fixed amount. I.R.C. v. British Salmson Aero Engines Ltd [1938] 2 K.B. 482 may suggest that receipts in a series not expressed to be instalments of a fixed amount, may be regarded as for the use of property and thus income derived from property: the conclusion that they are for the use of property would be drawn from the element of recurrence of receipts. Where the receipts relate to non-renewing land resource, a conclusion that they are income as gains from property may be thought inappropriate. There is no gain, save to the extent of any profit which would be income under Proposition 14. A conclusion that the receipts are income derived from property is no more appropriate than a conclusion that they are an annuity within the periodical receipts principle, when there would be equal conflict with the principle that gain is an essential quality of income.

2.319 There is other authority, considered later in relation to receipts in respect of commercial and industrial property, which would suggest that a single amount will be income if it is calculated by reference to actual use already made of the taxpayer's property, or, perhaps, by reference to prospective user. The cases are Constantinesco v. R. (1927) 11 T.C. 730 and Mills v. Jones (1929) 14 T.C. 769. In British Salmson, Greene M.R. cast doubt on the authority of the second case so far as it concerned a receipt for prospective user, pointing out that in that case the House of Lords said that the amount for prospective user was so negligible that it might be disregarded. The doubt appears to be forgotten in later pronouncements by the same judge in Nethersole v. Withers [1946] 1 All E.R. 711 and by Lord Denning M.R. in Murray v. I.C.I. Ltd [1967] Ch. 1038 at 1052, referring to Nethersole v. Withers. Lord Denning said: “If,
and in so far as, he disposes of the patent rights outright for a *lump sum*, which is arrived at by reference to some anticipated quantum of user, it will normally be income in the hands of the recipient (see the judgment of Greene M.R. in *Withers v. Nethersole* sub nom. *Nethersole v. Withers* [1946] 1 All E.R. 711 at 716; approved by Viscount Simon in the House of Lords [[1948] 1 All E.R. 400]).” The approval by Lord Simon did not extend to the specific statement by Greene M.R. (at 716) that: “If the lump sum is arrived at by reference to some anticipated quantum of user it will, we think, normally be income in the hands of the recipient.” Indeed Lord Simon drew attention (at 403) to the fact that in *Mills v. Jones* the amount for anticipated user was negligible.

2.320 If the pronouncement by Greene M.R., approved by Lord Denning, is correct, the actual circumstances in *Stanton* may attract the gains from property principle. The amount of the consideration was calculated by reference to the amount of timber thought to be in the stand of timber the buyer was authorised to take. There was provision that if the stand of timber did not include as much as was anticipated, there would be an abatement of the amount to be paid by the buyer.

2.321 If it is relevant that an amount has been calculated by reference to past user or to anticipated user, the question will arise as to how it is to be determined that an amount was so calculated. The view of Greene M.R. in *British Salmson Aero Engines* [1938] 2 K.B. 482 at 495 is that it is proper to pursue a wide inquiry, which may extend beyond the terms of the contract. He said: “Nothing that I say must be taken to be expressing the view that, in ascertaining the answer to the question whether or not a payment is to be regarded as a capital or an income payment, it is illegitimate to look outside the terms of the contract. I do not wish to lay down any such proposition. What has to be ascertained in these cases is the true nature of a payment; that is to say, the true nature from an accountancy point of view, and that is a question of fact. I do not wish to say anything which will have the effect of circumscribing the matters which may properly be looked into in answering that question of fact.”

2.322 Where an amount is received in a single payment in respect of the taxpayer's rights, and is not shown to be calculated by reference to user, it would be assumed, based on inference from *Stanton* and *White*, that the receipt is not a gain derived from property. Again, however, cases concerned with receipts in respect of commercial and industrial property may be difficult to reconcile with the assumption. Those cases may appear to stand for a proposition that a single amount received for the grant of a non-exclusive licence will be income. A passage from the judgment of Lord Denning M.R. in *Murray v. I.C.I. Ltd* [1967] Ch. 1038 at 1052 may
summarise the effect of the cases: “If, and in so far, as [a taxpayer] disposes of [patent rights] outright for a *lump sum* which has *no reference* to anticipated user, it would normally be capital (such as the payment of £25,000 in the *British Salmson* case). It is different when a man does not dispose of his patent rights, but retains them and grants a non-exclusive licence. He does not then dispose of a capital asset. He retains the asset and he uses it to bring in money for him. A lump sum may in those cases be a revenue receipt: see *Rustproof Metal Window Co. Ltd v. Inland Revenue Commissioners* [1947] 2 All E.R. 454 at 459 per Lord Greene M.R., who emphasised that it was a non-exclusive licence there. Similarly, a lump sum for ‘know-how’ may be a revenue receipt. The capital asset remains with the owner. All that he does is to put it to use” (emphasis in original).

2.323 It may not be clear from the passage quoted that the income quality of the receipt is given by the gains from property principle. The observations about a lump sum for know-how are based principally on *Rolls-Royce v. Jeffrey* [1962] 1 W.L.R. 425, where statements are made to the effect that the taxpayer had gone into business selling its know-how. In *Rustproof Metal Window*, however, there was no basis for any suggestion that the taxpayer had gone into business of granting non-exclusive licences. And indeed the lump sum amount in that case was held to be investment income, which would suggest that the relevant principle was the gains from property principle.

2.324 It would seem to follow that a receipt in the circumstances of *Stanton* is income under the gains from property principle, whether or not it is calculated by reference to anticipated user. There is, however, a difference to be drawn between the use of land by taking something from the land, and a use which does not involve any such taking. The facts in *Stanton* may be contrasted with a simple licence to enter the property of another. The latter may be seen as the equivalent of the licence in *Rustproof Metal Window*. Where possession and a right to take from the land is transferred to another

2.325 The discussion under the previous heading has been concerned with circumstances in which rights have been retained by the taxpayer who has given a licence to another. The licence in those circumstances will make lawful, acts done in exercise of the licence, but it will not preclude the continued exercise of his rights by the taxpayer, so far at least as this exercise does not deny the exercise by the other of the licence.

2.326 Attention is now directed to circumstances in which rights are transferred to another. Where rights are transferred by the taxpayer in a lease or sub-lease the characterisation of receipts will depend in part on the operation of the principles already discussed under the heading “rent”. It
may be, however, that in addition to giving possession under a lease, the lessor has given the lessee the right to cut the timber on land or to take minerals from it, or to exercise mining rights that the taxpayer may have been granted by the Crown. These circumstances are one step further removed from the idea of allowing the user of rights (as in the simple licence) than McCauley or Stanton. For this reason one might have expected an unwillingness to see any receipt as a gain derived from property. However, authorities in relation to exclusive licences in respect of commercial and industrial property rights may suggest that in some instances where possession has been given, with rights to take timber or minerals from land, or to exercise mining rights, receipts will be income as gains derived from property.

2.327 A series of payments triggered by the actual exercise of rights by the person to whom rights have in substance been transferred by the taxpayer will be income of the taxpayer where the rights are those inhering in items of commercial or industrial property. There is a transfer in substance where an exclusive licence is given—exclusive in relation to others and the taxpayer himself—reinforced perhaps by a keep-out covenant. It went without question in Murray v. I.C.I. Ltd [1967] Ch. 1038 that the payments called “royalties” relating to the exclusive sub-licences, were gains derived from property. And there was a clear assumption that the payments made by I.C.I. for the exclusive head-licence from the Calico Printers' Association were income derived from property in the hands of the Association. An exclusive licence in respect of an item of commercial or industrial property is in substance a partial disposition of rights inhering in the item of property, at least when the item, as in the case of a patent or copyright, has only a limited life. To regard the receipts called royalties in Murray v. I.C.I. as income derived from property is to treat as pure gains, receipts which may in truth be gains only to the extent of an element of profit. The consequence is parallel with the consequence of treating purchased annuity receipts as income.

2.328 It would follow from the treatment of payments triggered by the use of commercial or industrial property rights under an exclusive licence, that payments triggered by the use of land where possession has been given with a right to take timber or minerals from the land, or where there has been a lease of mining rights, will be income.

2.329 In the context of commercial and industrial property rights, I.R.C. v. British Salmson Aero Engines Ltd [1938] 2 K.B. 482, discussed in this connection in [2.318] above, is authority that a series of receipts not triggered by use, provided they are not instalment receipts of a fixed amount, will be regarded as being for the use of property and thus income.
derived from property. *British Salmson* involved an exclusive licence in respect of patent rights, and it may establish a principle equally applicable to an exclusive licence in respect of land of the kind now under discussion. Again the consequence that the series of receipts are income derived from property may be thought inappropriate. The receipts are not pure gain, more especially when the use under the licence involves taking a non-renewing resource such as minerals. A conclusion that the receipts are income derived from property is no more appropriate than a conclusion that they are an annuity. The latter conclusion will also conflict with the principle that gain is an essential quality of income.

2.330 The possibility that a single sum receipt for giving possession of land with a right to take timber or minerals from the land, or for the grant of a lease of mining rights, will be income derived from property where it is calculated by reference to user, cannot be dismissed. The effect of the decisions and of the observations made in *Constantinesco v. R.* (1927) 11 T.C. 730, *Mills v. Jones* (1929) 14 T.C. 769, *I.R.C. v. British Salmson Aero Engines Ltd*, *Withers v. Nethersole* [1948] 1 All E.R. 400 and *Murray v. I.C.I.* [1967] Ch. 1038 were considered above in [2.319]. It may be assumed that the law in relation to exclusive licences in respect of items of commercial or industrial property is transferable to the giving of possession of land with rights to take from the land. Here too the consequence that the receipt will be income may be thought inappropriate.

2.331 In one instance the law in relation to exclusive licences in respect of commercial and industrial property yields an appropriate result when transferred to the giving of possession of land. *Murray v. I.C.I.* is authority that the grant of an exclusive licence for the remainder of the term is not to be distinguished from an outright disposition of patent rights, and an outright disposition for a single sum that has no reference to anticipated use “will normally be capital” (at 1052, per Lord Denning M.R.). The words quoted leave the possibility that the taxpayer is dealing in patent rights, or for some other reason the patent is a revenue asset of a business. In which event the single sum receipt may reflect a profit which is income under Proposition 14. What is true of a single sum in respect of an exclusive licence for the remainder of the term is also true of a single sum in respect of an exclusive licence for a lesser period. In *British Salmson*, the period was 10 years. Where the land is wholly disposed of to another

2.332 If there is difficulty in accepting principles established in relation to exclusive licences in respect of commercial and industrial property where ownership is retained by the taxpayer, there is even greater difficulty in accepting those principles if they are extended to circumstances in which there has been an outright disposition of the rights comprised in such
property. Yet it seems they will be so extended. *Murray v. I.C.I.*, in effect, equates the giving of an exclusive licence for the remainder of the term of a patent with the disposition of the patent itself, and would regard principles applicable to exclusive licences generally as applicable to outright dispositions. The question now is the relevance of those principles where there has been an outright disposition of land.

2.333 In *Cliffs International Inc.* (1979) 142 C.L.R. 140 at 151 Barwick C.J. offered the observation that Howmet and Mt Enid would derive income when they received the payments by Cliffs International: “I would find it difficult to accept that [the receipts were] capital receipt[s] in the hands of the vendor.” Howmet and Mt Enid had sold their shares—amounting to all the shares—in a company, Basic, which had mining rights. Part of the consideration for the sale of the shares involved payments by the buyer, Cliffs, which would be triggered by the taking of ore in exercise of the mining rights. Cliffs had obtained title to the mining rights by liquidating Basic, and had then licensed other companies to exercise the mining rights. Barwick C.J. did not give reasons in support of his observation save what might be inferred from statements that the receipts were in the “nature of royalties” and that Cliffs had admitted the vendors “to participation in the result of the mining”. The idea of royalties in the sense of payments for user has become in this context, extremely remote. The more likely reason is that the vendor of the shares is participating in another's income. A principle that receipts in a series are income where they involve sharing in another's income was examined in [2.205]-[2.206] above.

2.334 *Minister of National Revenue v. Spooner* [1933] A.C. 684 was concerned with a sale of land in consideration of which the purchaser agreed to give the vendor, inter alia, a percentage share of the oil to be obtained from the land sold. The question was whether amounts received by the vendor from the purchaser in respect of her share of the oil as it was produced, were income of the vendor. The Privy Council observed that “capital may . . . be expended in the acquisition of an income which, in the recipient's hands becomes a proper subject of income tax” (at 689). Reference was made to the decision of Rowlatt J. in *Jones v. I.R.C.* [1920] 1 K.B. 711 ([2.206] above). To this point the judgment supports the outcome in *Just* (1949) 23 A.L.J. 47 and would support a conclusion of income character for the receipts in *Cliffs International*. The Privy Council however proceeded (at 690) to cite *I.R.C. v. Marine Turbine Co. Ltd* [1920] 1 K.B. 193 where Rowlatt J. had reached a conclusion apparently at odds with his own decision in *Jones v. I.R.C*. The liquidators of one company had sold its assets, including certain patent rights, to a new company for a
sum in cash, a block of shares and a “royalty” on every machine sold. Rowlatt J. characterised the royalties as being “in effect payment by instalments of part of the price of the property” disposed of to the new company. The Privy Council declined to alter the decision of the Canadian court from which the appeal had been taken, a decision in line with Marine Turbine, saying that it had not been shown to be “manifestly wrong”. In the result the Privy Council decision makes no contribution to principle.

2.335 It is temptingly simple to treat receipts triggered by user as income derived from property, even though the receipts are evidently proceeds of realisation of property. The tax accounting problems in calculating a profit are avoided, and there will be income as to the whole of the receipts when the profit might escape as a capital gain. But simplicity is achieved at a cost to the principle that gain is an essential quality of income, and to the principle that the quality of a receipt as income must be judged in the hands of the person who derived it.

Where the receipts are in respect of a partial disposition of rights, as in the case of an exclusive licence which is for part only of the term for which the rights will subsist, there may be some reason to say that the receipts are for the gains that would have been derived from the use of the property had the exclusive licence not been given. There is support for such an approach in the operation of Proposition 15 (the compensation receipts principle) as demonstrated in London and Thames Haven Oil Wharves Ltd v. Attwooll [1967] Ch. 772, involving the partial destruction of property. Where, however, rights are wholly disposed of, a characterisation of receipts as for the gains that would have been derived leads to conclusions which will destroy the distinction between an asset and the income flows which that asset may generate. Where an asset is disposed of, the purchase price will reflect the income flows which that asset might be expected to generate, but it would not be suggested that the proceeds of sale received in a single amount are therefore income. It may then be asked why it should make a difference that there is not one but several receipts.

2.336 It may be that the observation of Barwick C.J. in Cliffs International could be supported by pointing to the circumstances that persuaded Jacobs J. that the payments were deductible. Howmet and Mt Enid would continue to receive amounts for the whole period of the remaining life of the mine. It was therefore appropriate to regard the receipts as being for the gains that would have been derived if the property had been retained and exploited. In this regard the corporate veil between the shareholders, Howmet and Mt Enid, and Basic would need to be ignored.

2 K.B. 482, considered in [2.318]ff. above, may require that the receipts be regarded as income. *British Salmson* involved an exclusive licence for a period less than the remaining life of the patent and not an outright disposition of the patent, and there may be reason for distinguishing the case on that ground. The possibility that the series of receipts will be income as periodical receipts is raised in the judgment of Lord Denning M.R. in *Murray v. I.C.I.* [1967] Ch. 1038 at 1052: “A man may dispose of a capital asset outright for a lump sum, which is then a capital receipt. Or he may dispose of it in return for an annuity, in which case the annual payments are revenue receipts.” The context involved the grant of an exclusive licence for the remaining term of a patent. It was evident in the discussion, earlier in this Volume, of the periodical receipts principle (Proposition 11), that the United Kingdom authorities have shown an unwillingness to treat as periodical receipts a series of receipts which are the consideration on the sale of an asset. In this respect, the United Kingdom courts have been moved by an unwillingness to reach a conclusion which will offend the principle that gain is an essential quality of income. The Australian courts may appear to be less unwilling. But the Australian cases—*Just* (1949) 23 A.L.J. 47 and *Egerton-Warburton* (1934) 51 C.L.R. 568—do not justify a conclusion that a series of receipts, fixed in number and amount, will be income where they are the consideration on the sale of an asset.

2.338 There is some prospect, based on the United Kingdom commercial and industrial property cases, that a single sum calculated by reference to user will be income though it is the consideration for the outright disposition of rights. The United Kingdom cases are discussed above in [2.319]ff. and [2.371]ff. There is authority outside of the commercial and industrial property context and the present context of rights to take timber or minerals, which would assert that it is not enough to give an income quality to an amount received in exchange for an asset that the amount was calculated by reference to the income that the asset might have generated. In one of the cases, *Van den Berghs Ltd v. Clark* [1935] A.C. 431, the receipt was in exchange for giving up an asset—a profit-sharing contract—which had a limited life. It may be thought unlikely, therefore, that a single sum receipt following the outright disposition of mining rights, however it is calculated, will be income as a gain derived from property. There will remain the prospect that the receipt is income, to the extent of any profit, under Proposition 14.

2.339 A single amount received on the outright disposition of mining rights which is not calculated by reference to use will not be income as a gain derived from property. It may, however, to the extent of any profit, be
income under Proposition 14.

Receipts in respect of commercial and industrial property rights

2.340 Discussion under this heading has been to a degree anticipated in dealing with receipts in respect of rights relating to land.

2.341 It is necessary to draw distinctions which follow the distinctions drawn in dealing with rights relating to land. Where monopoly rights are retained and a non-exclusive licence is given

2.342 A non-exclusive licence, in the words of Greene M.R. in *I.R.C. v. British Salmson Aero Engines Ltd* [1938] 2 K.B. 482 at 494, referring to a patent licence, is an undertaking not to “complain of what would otherwise have been an infringement”. A series of receipts triggered by the licensee's actions in reliance on that undertaking are gains derived from property and income within Proposition 12. Such receipts will normally be called “royalties” in the licence agreement. Receipts of this kind were, for example, called royalties in the agreements in *Rustproof Metal Window Co. v. I.R.C.* [1947] 2 All E.R. 454 and *Murray v. I.C.I. Ltd* [1967] Ch. 1038. This is a use of the word recognised as appropriate by the High Court in *Sherritt Gordon Mines Ltd* (1977) 137 C.L.R. 612. The idea of receipts in respect of the use of one's property by another is satisfied. The receipts are pure gains, and there is no conflict with the principle in Proposition 4 that gain is an essential quality of income.

2.343 Receipts in a series, which are not expressed to be instalments of a fixed amount, are gains derived from property and thus income even though they are not triggered by the licensee's actions. Such receipts will not normally be called “royalties” though they were so called in the agreement in *British Salmson. Sherritt Gordon Mines* does not answer the question whether the use of the word in this context is appropriate though it may suggest that it is not. The conclusion that the receipts are for the use of property is drawn from the element of periodicity. The series of receipts in *British Salmson* was £2,500 payable each year during the currency of the licence. The receipts were in respect of an exclusive licence which may justify some questioning of the conclusion that they were income. But in the context of a non-exclusive licence a conclusion that a series of receipts of this kind are income would not be questioned. The receipts are pure gains, and there is no conflict with the principle that gain is an essential quality of income.

2.344 Where the consideration for a non-exclusive licence is a single amount which has been calculated by reference to actual use already made of the taxpayer's monopoly rights, or by reference to prospective use, the
single amount will be within the gains from property principle. Observations by Greene M.R. in *British Salmson* and in *Nethersole v. Withers* [1946] 1 All E.R. 711 and by Lord Denning M.R. in *Murray v. I.C.I.* were referred to and commented on in [2.319]ff. above. Those observations suggest that a single amount so calculated will be income even though the licence is exclusive, and to that extent there may be reason to question them. Where, however, the single sum is received under a non-exclusive licence, a conclusion that it is for the use of the monopoly rights would not be questioned. The receipt is pure gain. At least one of the cases referred to in the observations by Greene M.R. and Lord Denning M.R., namely, *Constantinesco v. R.* (1927) 11 T.C. 730, did not involve an exclusive licence.

2.345 Where the consideration for a non-exclusive licence is a single amount not calculated by reference to past or future use, it may be income as a gain derived from property. A relevant passage from the judgment of Lord Denning M.R. in *Murray v. I.C.I.* was quoted in [2.322] above. Lord Denning M.R. referred to *Rustproof Metal Window Company Ltd v. I.R.C.* where a single amount was held to be income when received in respect of a non-exclusive licence. The possibility that the receipt will be income only where it is a business receipt was considered in [2.323] above, but rejected. Where an exclusive licence in respect of monopoly rights is given to another

2.346 The intention is to deal under this heading with receipts under exclusive licences. It was assumed without question in *Murray v. I.C.I. Ltd* [1967] Ch. 1038 that the payments called “royalties” relating to the exclusive sub-licences were income as gains derived from property. The payments were triggered by sales of the product to which the patent related. It may be inferred from *Sherritt Gordon Mines Ltd* (1977) 137 C.L.R. 612 that such payments would properly be described as “royalties” in the hands of the licensor. Whether they should be regarded as gains derived from property and thus income by ordinary usage is a distinct issue. The suggestion was made in [2.327] above that to regard them as income is to treat as pure gains receipts which may be gains only to the extent of an element of profit. There is the same offence to a principle that gain is an essential quality of income as there is in treating the whole of the receipts of a purchased annuity as income.

2.347 It may be thought that the series of receipts now considered are indistinguishable in principle from rent paid under a lease of land. This may be true where the item of commercial or industrial property is perpetual, like a trade-mark. Where however the item of property, as in the case of a copyright or patent, has only a limited life, the series of receipts
are distinguishable from rent. These receipts, most obviously when the exclusive licence is for the whole of the remaining term of the item of property, are in substance proceeds of the realisation of the item of property.

2.348 *I.R.C. v. British Salmson Aero Engines Ltd* [1938] 2 K.B. 482 is authority that a series of receipts under an exclusive licence, though not triggered by use, will be income derived from property, provided they are not instalment receipts of a fixed amount. There is a conflict with the principle that gain is an essential quality of income. *Sherritt Gordon Mines Ltd* (1977) 137 C.L.R. 612 does not answer the question whether such receipts would properly be called royalties, though it may suggest that they would not. They were referred to as “annual payments” by Lord Denning in *Murray v. I.C.I.*

2.349 The distinction between instalment receipts of a fixed amount and a series of receipts, which must be drawn in this context, has its parallel in the distinction between instalment receipts of a fixed amount and periodical receipts considered in relation to Proposition 11. It may be noted that in *British Salmson* the payments made under the agreement to pay £25,000, as to £15,000 on the signing of the agreement and two amounts of £5,000 at intervals of 6 months, were held to be instalments of the £25,000. On the other hand payments under the agreement to pay £2,500 during each year of the currency of the licence, were treated as a series. It may be asked whether like payments required only for the first 9 years of the currency of the 10 year licence would have been treated as a series. In the discussion of the receipts by Howmet and Mt Enid in *Cliffs International Inc.* (1979) 142 C.L.R. 140 in [2.336] above, it is suggested that payments which are called for during the whole of the life of the rights transferred might be treated differently from payments required over a different period.

2.350 A single amount received in respect of past use under an exclusive licence, and calculated by reference to that use, will, it seems, be income, equally with a series of receipts triggered by use. The authority is statements by Greene M.R. in *British Salmson* and in *Nethersole v. Withers* [1946] 1 All E.R. 711, and by Lord Denning M.R. in *Murray v. I.C.I.* Those statements were considered above in [2.319]ff. It is doubtful whether a single amount received in respect of future use under an exclusive licence will be income simply because it has been calculated by reference to anticipated future use. Greene M.R. in *British Salmson* was unwilling to draw a conclusion from *Mills v. Jones* (1929) 14 T.C. 769, that a single amount of this kind is income derived from property. That case was concerned with a payment in respect of use made by the Crown
of a patent under a provision in the patents legislation allowing use for the services of the Crown. The use was not, it seems, exclusive as a matter of legal right, though it may have been exclusive in fact. Later in *Nethersole v. Withers* Greene M.R. appeared to accept *Mills v. Jones* as authority in regard to an exclusive licence. Though his judgment was not endorsed by Viscount Simon in the House of Lords (sub nom. *Withers v. Nethersole* [1948] 1 All E.R. 400), it was accepted as a correct statement of the law in *Murray v. I.C.I.* by Lord Denning, who mistakenly treated it as endorsed by Viscount Simon. Whatever the effect of the authorities, it may be said that treating a single amount for an exclusive licence as income derived from property, simply because it has been calculated by reference to an estimate of future use, would be an unjustified extension of the notion of income derived from property.

2.351 A single amount received for the grant of an exclusive licence which has not been calculated by reference to past or prospective use, will not be income derived from property. *British Salmson* is authority for this proposition. It is accepted as authority by Lord Denning M.R. in *Murray v. I.C.I.* [1967] Ch. 1038 at 1052 and by Cross J. in the same case at first instance ([1967] 1 W.L.R. 304 at 313). It is accepted by Campbell J. in *Kwikspan Purlin System Pty Ltd* (1984) 84 A.T.C. 4282. Where the monopoly rights are wholly disposed of

2.352 If a receipt in respect of an exclusive licence in relation to monopoly rights is not income derived from property, a like receipt in respect of an outright disposition of monopoly rights will not be income derived from property.

2.353 If a receipt in respect of an exclusive licence is income derived from property, it may yet be held that a different conclusion is appropriate where the receipt is in respect of an outright disposition. Whatever relevance it may have in the context of an exclusive licence, the notion of a receipt for the use of property seems not to be relevant when there has been an outright disposition of the property to the person who uses it. None the less it would appear accepted that a series of payments triggered by use of monopoly rights by the person who now owns those rights is income of the former owner as income derived from property. Thus, in *Murray v. I.C.I. Ltd* [1967] Ch. 1038 at 1052, Lord Denning said: “it seems to me fairly clear that if, and in so far as, a man disposes of patent rights outright . . . and receives in return royalties calculated by reference to the actual user, the royalties are clearly revenue receipts.” The description “calculated by reference to actual user” is, presumably, equivalent to the description adopted in [2.314] as “triggered” by actual use. There is an offence to the principle that gain is an essential quality of income if the whole of the
receipts are treated as income. The notion of income is not accretions to economic power but, it seems, the receipt of a share of income of another explained in [2.333] above, and again in [2.363]ff. below.

2.354 It may be inferred from Sherritt Gordon Mines Ltd (1977) 137 C.L.R. 612 and from language used in the quotation in the last paragraph from the judgment of Lord Denning, that the use of the word “royalties” is appropriate to describe receipts triggered by the use of monopoly rights which have been the subject of an outright disposition. The receipts would thus be income under s. 26(f) whatever view is taken of their character as income derived from property.

2.355 If it is accepted that receipts triggered by use are income derived from property notwithstanding that there has been an outright disposition of the property, it must follow that other receipts in respect of an outright disposition will be income derived from property, if they are receipts which would have an income quality as receipts in respect of an exclusive licence. Again the judgment of Lord Denning in Murray v. I.C.I. may be relied upon. He said (at 1052): “If, and in so far as, he disposes [of patent rights outright] for annual payments over the period, which can fairly be regarded as compensation for the user during the period, then those also are revenue receipts.” And he added: “If, and in so far as, he disposes of the patent rights outright for a lump sum, which is arrived at by reference to some anticipated quantum of user, it will normally be income in the hands of the recipient.” It has been suggested above, that the latter quotation may go further than the authorities warrant. Both quotations, involve some offence to the principle that gain is an essential quality of income.

Receipts in respect of the supply of know-how

2.356 In the discussion so far under the heading “royalties” a number of references have been made to the decision of the High Court in Sherritt Gordon Mines Ltd (1977) 137 C.L.R. 612 as to the meaning of the word “royalties” used in s. 6C of the Assessment Act. The court was called on to give the word a meaning without the aid of the definition in s. 6 which, as it was then drafted, was held to be inapplicable. Mason J. (who with Gibbs A.C.J. constituted the majority) described the court's role as one of determining the scope of “ordinary royalties”. He relied (at 626) on Stanton (1955) 92 C.L.R. 630 for a conclusion that “it is of the essence of a royalty that the payments should be made in consideration of the grant of a right, that they should be made in respect of particular exercises of the right and therefore should be calculated in the manner stated”. The “manner stated” is a reference to that described in Stanton (at 642) as “in
respect of the quantity or value taken or the occasions upon which the right is exercised”.

2.357 As so identified, royalties will cover all the payments triggered by use so far examined, where the use is by virtue of a non-exclusive licence given to the payer by the payee. The meaning may be wider. It very likely extends to payments triggered under exclusive licence arrangements. Indeed, the “grant of right” is a more apt description of an exclusive licence than of a non-exclusive licence. In *I.R.C. v. British Salmson Aero Engines Ltd* [1938] 2 K.B. 482 Greene M.R. referred to a non-exclusive patent licence as an undertaking not “to complain of what would otherwise have been an infringement”. The licensee, it could be argued, does not have a right granted to him. He merely has an undertaking that the owner of the right will not complain.

2.358 There is a question whether Mason J. intended his description to cover a situation where the right granted is granted as part of an outright disposition of the relevant congeries of rights—the patent, copyright or trademark itself. If he did, it would follow that all the uses of the word “royalties” in the passages quoted above from the judgment of Lord Denning in *Murray v. I.C.I.* would be correct uses. And it would follow that whatever might be the scope of the ordinary usage notion of income derived from property where the congeries of rights has been disposed of, payments triggered by the exercise of rights acquired from another and made to that other will be his income under s. 26(f).

2.359 *Sherritt Gordon Mines* is authority that the word “royalties” in its ordinary sense does not extend to payments which cannot be described as payments in respect of the exercise of rights granted to the payer by the payee. “Right” requires some extended meaning in the context to cover the correlative of a contractual undertaking not to complain, but there is no grant of a right where there is merely a “provision of technical assistance and information which [the payer is] entitled to use once it [is] supplied, without the grant of any additional right so to do” (at 626). It follows that the payments in respect of the provision of technical information and assistance in *United Aircraft Corp.* (1943) 68 C.L.R. 525 were not royalties in the ordinary sense of the word. Nor were the payments in consideration of the supply of technical knowledge to manufacture aircraft engines in *Rolls-Royce v. Jeffrey* [1962] 1 W.L.R. 425 properly described as royalties.

2.360 The view of the majority in *Sherritt Gordon Mines* contrasts with the view of the minority judge, Jacobs J., who took the view (at 631) that “[t]he essential feature of royalties in its ordinary acceptation is that the payments are calculated proportionately to the use or the production extraction or treatment consequent upon the use of that which is provided,
not the legal quality of that for which the payment is made”.

2.361 The conclusion that receipts for technical assistance and information, though calculated proportionately to the use or production consequent on the use of the assistance and information, are not royalties, prevents an operation of s. 26(f) to make them income. But it does not preclude a conclusion that they are income by ordinary usage. It was assumed in Rolls-Royce that such receipts were income. The case was concerned with single amount payments for supplies of know-how. These were held to be income. The decision is considered more closely in relation to Proposition 14. One explanation, and the most likely, is that Rolls-Royce had entered on a business of selling its know-how. If this is the only explanation, the case is not helpful in fixing the scope of the notion of income derived from property. The so-called royalties and the single sum amounts would be income as business gains. There is another possible explanation. The supply of know-how was a service performed by Rolls-Royce for the payer. The income nature of rewards for services is explored under Proposition 13. If this is the explanation, the case is still unhelpful in fixing the scope of the notion of income derived from property. In Kwikspan Purlin System Pty Ltd (1984) 84 A.T.C. 4282 Campbell J. held that lump sum receipts for know-how were not proceeds of a business. But the receipts in that case related not only to the supply of know-how but also to exclusive licences of patent rights. The supply of know-how in each case was auxiliary to the grant of the exclusive licence. The possibility that some part of each lump sum receipt was a reward for services was not considered in Kwikspan Purlin.

2.362 There is, however, a third possible explanation of Rolls-Royce: that the single sum receipts were income for the same reason as single sum receipts for the grant of non-exclusive licences of commercial and industrial property are income. The single sums are for the use of know-how which is property in the sense of that word in the formulation of the ordinary usage notion of income derived from property, and it is property retained by the grantor. If a single sum receipt is income for this reason, a series of receipts calculated proportionately to the use or production consequent on the use are a fortiori income.

2.363 Even if a single amount receipt for know-how fails to qualify as income under the income from property principle, a series of receipts calculated proportionately to the use or production may yet be income derived from property because they are within an extension of the principle which will bring it to the borders of, if not into, the periodical receipts principle. Its link with the periodical receipts principle was considered in [2.333] above. It was suggested that the receipts by Howmet and Mt Enid
in the facts of *Cliffs International Inc.* (1979) 142 C.L.R. 140 were income because they involved a sharing by those companies in the profits made by Cliffs International. It is true that in *Cliffs International* there had been indirectly a grant of mining rights by Howmet and Mt Enid. Those companies had owned shares in Basic and had sold those shares to Cliffs. The mining rights were at the time owned by Basic. Afterwards they were acquired by Cliffs by liquidation of Basic. The payments could therefore be described as made in respect of the exercise of rights granted to the payer by the payee. But the reasoning is forced. It would be more appropriate to recognise a principle which perhaps straddles the principle of income derived from property and the periodical receipts principle. This principle would assert that a series of receipts by which a payee shares in the income receipts of the payer are income of the payee, whether or not the consideration furnished by the payee was the grant of a right. The principle would give an income quality to the receipts by Howmet and Mt Enid and to the receipts by the taxpayer in *Just* (1949) 23 A.L.J. 47. The idea of sharing does not require that the payments be deductible in determining the taxable income of the payer though the fact that a deduction is not available to the person who pays must have a bearing on the question whether the principle of sharing applies to the taxpayer who receives. In *Colonial Mutual Life Assurance Society Ltd* (1953) 89 C.L.R. 428 the payer of the money, held to be income of the payee in *Just*, was denied a deduction. The principle of sharing would none the less offer a reason for treating as income, receipts for know-how supplied to another when the receipts are a series calculated proportionately to the use, or production resulting from use, of the know-how.

2.364 Like some applications of the periodical receipts principle, and of the income derived from property principle, the principle of sharing may treat as pure gain, receipts which are gain only to the extent of profit.

2.365 The principle that a series of receipts by which a payee shares in the income receipts of the payer are income of the payee, may explain why the receipts in *Aktiebolaget Volvo* (1978) 78 A.T.C. 4316 should be regarded as income. The question raised before Jenkinson J. was whether the receipts had an Australian source, and there was no attention given to whether they were income. The Swedish parent of Volvo Australia received annual payments from Volvo Australia calculated as a percentage of the value of sales of Volvo products in Australia by Volvo Australia. Answering the question of source in Australia called for a conclusion as to whether the receipts were royalties in the ordinary meaning of the word, so that they would have a source in Australia under s. 6C. A conclusion that they were such royalties would also have been a conclusion that they were
income under s. 26(f). Jenkinson J. concluded that the receipts were not royalties within the meaning given to the word by the majority in *Sherritt Gordon Mines Ltd* (1977) 137 C.L.R. 612. One observation made in the course of reaching that conclusion is surprising. He said (at 4321): “The remedies which the agreement affords Volvo Australia for competition in its trade in Volvo products are only against the appellant, not against others who engage in selling the products in Australia.” An inference would be that payments triggered by the exercise of a non-exclusive licence are not royalties, because the grant of a non-exclusive licence does not normally give rights save against the grantor.

2.366 A licence to use the parent company's Australian trade mark and associated goodwill might have been implied from the supply of cars to Volvo Australia. That licence was in effect converted into an exclusive licence by the agreement under which the payments were made. The consideration for the payments under the agreement was a covenant by the parent company not to supply any other person so that it might distribute Volvo products in Australia— in effect a keep-out covenant. Such a covenant in the view of Jenkinson J. did not involve the grant of a right, so that the receipts were not royalties. The Commissioner had argued that even if the receipts were not royalties, they were income and had a source in Australia. Jenkinson J. did not decide the question whether they were income, because he concluded that they did not have an Australian source under general principles. It would however be possible to argue that the receipts were income as payments for the exclusive use of the parent company's goodwill in Australia, in a sense property of the parent made available to Volvo Australia by the keep-out covenant. The more embracing argument would be that, whether or not there had been a grant of a right or a covenant indirectly making property available to Volvo Australia, the receipts by the parent were income as receipts by which it shared in the income of Volvo Australia.

**Proposition 13: A gain which is a reward for services rendered or to be rendered has the character of income**

The relationship of Proposition 13 to specific provisions of the Act

2.367 Proposition 13 is expressed, at least in part, in the specific provisions of s. 26(e). There are questions still unresolved as to the relationship between the ordinary usage principle and s. 26(e). In its terms, s. 26(e) applies only to benefits for “services rendered”. But it might yet be construed to extend to situations where services are to be rendered after the
time of derivation of the benefit. There is authority (for example, in *Scott* (1966) 117 C.L.R. 514, *Hayes* (1956) 96 C.L.R. 47 and *Dixon* (1952) 86 C.L.R. 540) that the connection between services and benefit which will make the item income as a reward for services, is no different under s. 26 (e) than it is under the ordinary usage principle. In one respect s. 26(e) is wider in its operation than the ordinary usage principle: s. 26(e), in the circumstances covered by the provision, displaces the ordinary usage principle that an item of an income character, that has been derived, is income only in the amount of its realisable value. The provision makes a benefit income in the amount of its “value to the taxpayer”. In other respects s. 26(e) may be narrower. Thus the words “allowed given or granted” may have a narrower operation than the principles of derivation applicable to ordinary usage income. Provisos to s. 26(e) exclude from the operation of the provision benefits which are covered by the “eligible termination payment” provisions of Subdiv. AA of Div. 2 of Pt III, or by s. 26AC or s. 26AD, or which are treated as dividends under any section of the Act. Where s. 26(e), within the field left to it by express provisions, has a narrower scope than the ordinary usage meaning of income in relation to rewards for services, the question is posed whether s. 26(e) is a code and the ordinary usage meaning of income is denied any operation. The matter is considered in [4.18] and [4.42] below.

2.368 The drafting of s. 26AAC(10), discussed in [2.25] above appears to assume that were it not for s. 26AAC, s. 26(e) would be a code in relation to shares or rights to shares acquired “under a scheme for the acquisition of shares by employees”. A conclusion that s. 26(e) is intended to be a code may leave unresolved questions as to the consequences of that conclusion. In relation to the former s. 26(d), *Reseck* (1975) 133 C.L.R. 45, by majority, held that the ordinary usage principle is simply excluded by the specific provision from any operation. The minority opinion of Stephen J., however, would regard as exempt income those benefits covered by the ordinary usage principle which are not made income by the code, though within its intended field of operation. The minority opinion expresses a view of the general relationship of ordinary usage principles and specific statutory provisions which is referred to at the outset of this chapter as the two meanings and parallel provisions analyses of the meaning of income and structure of the Assessment Act.

2.369 Amendments to the Assessment Act in 1984 repealed s. 26(d) and replaced it by the “eligible termination payment” provisions of Subdiv. AA of Div. 2 of Pt III. Associated with the repeal and replacement, words were added to s. 25(1) which except from its operation “an amount to which s. 26AC or s. 26AD applies, or an eligible termination payment within the
meaning of Subdiv. AA”. Comment on this addition to s. 25(1) has been made in [1.39] and [2.223] above. It does deny the central provision analysis of the Assessment Act argued for in this Volume, with resulting destructive consequences for the operation of the jurisdictional bases adopted by the Assessment Act. And the addition would appear to deny the single meaning analysis. If it does deny the single meaning analysis, reconciliation between s. 25(1) and specific provisions is possible only by further express exceptions to s. 25(1). Meanwhile s. 25(1) and specific provisions, other than those now listed in s. 25(1), enter upon a chaotic competition for precedence, with the only prospect of relief being that afforded by the analysis of Stephen J. in Reseck: where a specific provision has a narrower operation in a field than the ordinary usage concept, the difference becomes exempt income, a relief that could never have been intended and which no one would welcome. It would be a strange conclusion indeed that s. 26AAC has made a receipt of options within Abbott v. Philbin [1961] A.C. 352 exempt income.

2.370 The problems of reconciliation between the operation of ordinary usage principles and specific provisions are no different from the problems of reconciliation of specific provisions. They ought where possible to be solved by express provisions like those in the provisos to s. 26(e). Where there is no express provision, principles of statutory interpretation and what policies may be evident in the Assessment Act and legislative history must govern. There is a problem, for example, of reconciling s. 26AAC and the eligible termination payment provisions which must be solved in this way. An eligible termination payment may be a transfer of shares to which s. 26AAC on its facts applies (s. 27A(8)).

2.371 The words added to s. 25(1) should be replaced by words in Subdiv. AA, s. 26AC and s. 26AD themselves, which will state their relationship to the ordinary usage meaning of income. It will be a happy bonus that the central provision and single meaning analyses will be restored, and the jurisdictional bases of the Assessment Act repaired.

2.372 The view adopted in this Volume—that there is only one meaning of income for purposes of the Act and that s. 25 is a central provision which in its use of the word “income” refers to all items which are income for purposes of the Act—simplifies the solution of the problems of relationship. The majority view in Reseck is explained as a decision that s. 26(d) exclusively determined when a benefit to which the provision applied was income. Section 26AAC(10), in partially excluding the operation of s. 26(e), is seen as denying an income quality to items which are within that exclusion and which are not given an income quality by s. 26AAC.
2.373 Whatever may be the scope remaining for the ordinary usage notion of income so far as it concerns rewards for services, it must continue to be indirectly relevant in the interpreting of the specific provisions. The point has already been made that the words “in respect of, or for or in relation directly or indirectly to” in s. 26(e) will be taken to reflect the tests of connection which in relation to the ordinary usage notion are described as tests of whether a benefit is a product of services. The idea of product of services where the benefit is in the nature of a gift received by the taxpayer who performs services, has already been examined under Proposition 8.

**Reward for services and gain from an employment, or a business or profession of rendering services**

2.374 The ordinary usage principle that a reward for services is income, like the specific provision in s. 26(e), applies whether or not the services are rendered in some employment relationship. And it applies though the services are rendered in some isolated transaction which is not part of a continuing business or profession of rendering services.

2.375 The first of these statements hardly requires authority. For the second the Australian authority is **Brent** (1971) 125 C.L.R. 418. The issue in the case, as it was seen by Gibbs J., was whether Mrs Brent, in communicating her story to the newspaper, was rendering a service or disposing of property. If the correct conclusion was that she was disposing of property the income quality of the receipt would have turned on the operation of Proposition 14—gain from carrying on a business or carrying out an isolated business venture—or, conceivably, on the specific provisions in s. 26(a) (now s. 25A(1)) and s. 26AAA. Proposition 14, it will be seen, would not give an income quality to any part of the proceeds of sale unless a business is being carried on and the sale is an aspect of carrying on the business, or is incidental to carrying on the business, or the sale is the carrying out of an isolated business venture. There was no suggestion that Mrs Brent had entered on a business of selling stories or was carrying out an isolated business venture, and neither s. 26(a) nor s. 26AAA could possibly have been relevant. Seen as a disposition of property, the selling of the story could not therefore have involved a gain that was income. Gibbs J. held that the communicating of the story was the performance of a service, and the reward she would receive would therefore have an income character. He relied on the United Kingdom cases of **Hobbs v. Hussey** [1942] 1 K.B. 491 and **Housden v. Marshall** [1959] 1 W.L.R. 1, and quoted (at 426) from the judgment of Lawrence J. in **Hobbs v. Hussey**:
“... the performance of services, although they may involve some subsidiary sale of property (e.g. dentures sold by a dentist) are in their essence of a revenue nature since they are the fruit of the individual's capacity which may be regarded in a sense as his capital but are not the capital itself.”

The distinction between selling property and selling services in circumstances such as Brent may appear artificial and complicating. If Mrs Brent had sold the family photo album as well as her story, an awkward problem of determining what is principal and what is subsidiary would have been posed.

2.376 None the less, the consequence of Brent is that the distinction between selling services and selling property becomes of fundamental importance in income tax law. A reward for an isolated act of service—occasionally acting as a baby-sitter, or returning lost property to its owner—which may fairly be regarded as a product of that service, will be income. Presumably, it will not be regarded as a product unless the act is performed in a commercial context to the extent that the taxpayer expected a reward. But gain from selling property (save where s. 25A(1) or s. 26AAA operates) will be income only where the property is a revenue asset of a business, or is realised in carrying out an isolated business venture.

2.377 The implications of the distinction drawn in Brent are not always clearly seen. A passage from the judgment of Fullagar J. in Hayes (1956) 96 C.L.R. 47 at 57–58 calls for quotation at length:

“The only other way, so far as I can see, in which the case can be put for the commissioner is to say that the gift of the shares represented a reward or recompense for the general advice and guidance given informally on a number of occasions to Richardson personally, and proving of benefit in the long run to Richardson himself or to the company in which he had a controlling interest. I think that the gift was intended in part, though only in part, as such reward or recompense. But surely it is utterly unreal to say that, whenever Hayes expressed a particular opinion or recommended a particular course, he was engaging in an activity capable of producing income for him. Such an idea is foreign to the whole idea of what constitutes income from personal exertion. If Hayes had been employed to give such advice or guidance, or if he had carried on a business of giving such advice or guidance, the position might well have been different. But he was doing neither of those things. If A tells his friend B in a casual conversation that he thinks that the shares of the Z company will rise greatly in a short time, and B buys shares in the Z company and makes a large profit, it will be impossible to contend that a gift of £1,000 by a grateful B to his friend A is income earned by A. A has earned the money only in the loose sense that he has done something for which B is grateful. He has not earned it in the sense—the only relevant sense—that it is the product of a revenue-earning activity on his part.”

2.378 The reasoning in the passage quoted shifts between two lines. One of these is that the receipt by Hayes was not a product of the services: the
absence of an expectation of the receipt by Hayes, and the motive of
grateful judgement rather than the giving of reward that may have moved
Richardson, were relevant. The other line of reasoning is reflected in the
hypothesis and conclusion that: “If Hayes had been employed to give such
advice or guidance, or if he had carried on a business of giving such advice
or guidance, . . . the position might well have been different.” This second
line of reasoning is inconsistent with the decision in Brent. It assumes that
a reward for services is income only when the services are performed in an
employment relationship or as an activity of a business. The reasoning in
Maddalena (1971) 45 A.L.J.R. 426 may also be inconsistent with Brent.
The question was whether the taxpayer, a professional footballer, was
titled to deduct expenses incurred by him in seeking and obtaining a new
contract with a new club to play football. In the view of the court a
taxpayer who has no business of providing services has no income earning
activity of providing services until he has an employment contract. On the
authority of Brent there ought to have been some consideration given to
whether the expenses were expenses of an activity of performing services
from which he might derive rewards that were income. In fact the
reasoning in Maddalena assumed that the expenses could only be
deductible as expenses of an employment or as expenses of a business of
rendering services. They were “incurred in getting, not in doing, work as
an employee”. They were not the latter because, on a technical view of the
distinction between a contract of service and a contract for services, the
taxpayer was seeking employment and thus could not have a business.
Menzies J. (with whom all the other judges agreed) said (at 427):

“There is a difference of first importance for present purposes between an
electrician who seeks work as an employee and an electrician who seeks contracts to
do work as a principal. In the former case the electrician would not have a business;
in the latter he would. In the latter, therefore, what he spent to obtain contracts to do
electrical work would be properly regarded as an outgoing of his business. There is,
however, a clear distinction between the two cases.”

Granted that there is a distinction thus drawn by Menzies J., it may yet be asked
whether there is a relevant distinction. The distinction will not be significant if the
rendering of services, irrespective of any business context, is an activity that may
produce income. The fact that expenses are directed to obtaining a contract of
employment that will provide continuing opportunities to provide services for reward,
is not significant in determining deductibility save so far as it bears on the question
whether the expenses are working expenses. They may not be working expenses
because the employment contract is of such importance that it is structural to the
taxpayer's activity. In the same way the expenses of an electrician in obtaining a
contract to do electrical work as an independent contractor may be structural, if the
contract will provide a very substantial part of the outlet for his services. The matter is
considered in [2.478]–[2.491] in connection with a distinction between revenue assets and structural assets of a business.

2.379 There is a question whether the distinction between selling services and selling property is relevant where actual services are provided, not by the taxpayer, but by another person who may be contractually bound to the taxpayer to perform services at the latter’s direction. A service trust, such as that involved in the facts of Phillips (1978) 78 A.T.C. 4361, may provide the services of its employees as an activity of a business and any reward is proceeds of that business. But a casual act of providing services—the services of the taxpayer’s secretary to take notes at a company meeting, the taxpayer being a director of the company—may not attract the principle in Brent.

Performance of services and supply of property

2.380 The distinction of fundamental importance drawn in Brent (1971) 125 C.L.R. 418 between performance of services and supply of property, must bring its share of problems. In Hobbs v. Hussey [1942] 1 K.B. 491 the sale of the copyright under the contract by which the services were supplied was held to be merely ancillary. There will be other cases where such a conclusion is not so easily reached.

2.381 In some cases it will not be necessary to draw the distinction because the taxpayer is in business and the property is a revenue asset of that business, or because the property is property to which s. 25A(1) applies: Austrotel Corp. Ltd (1976) 76 A.T.C. 4245. The gain will be income whether it results from the performance of services or the supply of property.

2.382 The importance of identifying occasions of the supply of services has been accentuated by the specific provision in s. 26(e), which displaces the principle expressed in Proposition 2, where an item is income as a reward for services. In Cooke and Sherden (1980) 80 A.T.C. 4140 the question was whether an item which had no realisable value, but which had a substantial value to the taxpayer, might be brought to tax as a reward for services. The taxpayer was technically a self-employed person acquiring property from a supplier for resale as his own property. The reward in question was a holiday paid for by his supplier. Section 26(e) was held to be inapplicable: to buy goods from another is not to perform a service for that other.

The distinction between a receipt which is a reward for services and a receipt for giving up a contract to perform services, or for accepting a restriction on one’s capacity to perform services
An examination of the meaning of income in ordinary usage requires that a distinction be drawn between a receipt that is a reward for services, and a receipt that is the consideration for giving up a contract to perform services. It also requires that a distinction be drawn between a receipt that is a reward for services and a receipt that is the consideration for accepting a restriction on capacity to perform services.

Receipt for giving up a contract to perform services

Where the taxpayer's actions amount to a business of performing services, a contract under which services are performed may be a revenue asset of that business and a receipt for giving up the contract will be income to the extent that it involves a gain. Its character as a revenue asset will depend on the significance of the contract to the business. The notion of revenue asset is explained in [2.478]–[2.491] below. A contract of employment may be a revenue asset as distinct from a structural asset of a business of providing services though the occasions when it will be a revenue asset are likely to be few. A conclusion that the contract of employment was a revenue asset of a business was reached by Starke J. in *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144.

Where a taxpayer is not engaged in a business of providing services, there is room for a characterisation of a contract to perform services which will parallel the characterisation of an asset as a revenue asset of a business. It may be enough to identify it in this characterisation as a non-structural asset. A contract which does not engage a significant part of a taxpayer's capacity to perform services may be non-structural, and a receipt for giving up the contract will be income. A contract of employment might be seen in some circumstances as non-structural. It was suggested in [2.378] above that the contract of employment entered into by the taxpayer in *Maddalena* (1971) 45 A.L.J.R. 426 could be seen as non-structural. There is no magic about a contract of employment which will require that it be always treated as structural. The technical distinction between an employment contract and a contract as an independent contractor should not be a definitive distinction in this part of the law. A contract of employment will normally be structural, however, and it is assumed to be such in the discussions that follow, whether it is or is not an asset of a business.

A receipt for giving up a contract to perform services that is a structural asset of a business, or an activity of providing services, will not be income under the ordinary usage concept, but it may be income under Subdiv. AA of Div. 2 of Pt III which includes a code of provisions that
relate to an “eligible termination of payment” as defined in s. 27A(1). Those provisions are made a code by words added to s. 25(1) in 1984 which have been the subject of comment in [1.39], [2.223] and [2.369] above. Subdivision AA is more closely considered in [2.419] and [4.138]ff. below where the range of its operation in excluding aspects of the ordinary usage concept of income from the meaning of income for purposes of the Assessment Act, is examined. With some exceptions, an “eligible termination payment” includes “a payment made in respect of the taxpayer in consequence of the termination of any employment of the taxpayer”. “Employment” is defined so that it includes “the holding of an office”. One function of Subdiv. AA is to give an income character to a receipt which is not income by ordinary usage, because it is a receipt for giving up a contract to perform services that is a structural asset. In addition Subdiv. AA, in conjunction with the words added to s.25(1) in 1984, will exclude from the character of income under the Act as income by ordinary usage an “eligible termination payment” that is a receipt for giving up a contract that is a revenue asset. And it will exclude from the character of income as income by ordinary usage a reward for services that is “an eligible termination payment”. An “eligible termination payment” is, however, income and subject to tax under ss 27B and 27C of Subdiv. AA which, when read with s. 160AA, afford various degrees of relief from tax.

2.387 In what follows, the ordinary usage principles are examined, with some references forward to the treatment in [4.138]ff. of Subdiv. AA of Div. 2 of Pt III. Distinguishing a receipt for giving up a contract and a receipt that is a reward for services

2.388 Where a taxpayer gives up all rights under a service agreement in exchange for a single sum of money, and ceases to perform services for the other party to the agreement, characterising the receipt as being for giving up the contract involves no difficulty. If the service agreement is structural, there will be no income within the ordinary usage meaning. There may however, be income in the form of an “eligible termination payment” under Subdiv. AA. If the taxpayer continues to render services under what may be seen as a modified agreement, or under a new agreement, a characterising of the receipt as being for the services to be performed in the future under the modified agreement, or under the new agreement, may appear to be open: *Henley v. Murray* [1950] 1 All E.R. 908. Where the only significant change in legal relations is that the taxpayer will hereafter work for a lower salary, the substance of the matter may be thought to be that the taxpayer has received a reward for services in advance of performing services. In *Cameron v. Prendergast* [1940] A.C. 549, the House of Lords, after some obeisance to the authority of *I.R.C. v. Duke of...*
Westminster [1936] A.C. 1, concluded that the agreement which modified the service agreement involved in “form and substance” a promise to continue to serve and the receipt was for that promise: it thus arose from his office as director and was income. In Tilley v. Wales [1943] A.C. 386 the agreement which modified the service agreement provided that the taxpayer would serve the company “as managing director as from the date of these presents at a reduced salary of two thousand pounds per annum”, and in consideration he would receive the sum of £40,000. The £40,000 was held to be income. Without referring to Duke of Westminster, Viscount Simon L.C. (at 393) concluded that the quality of income is not escaped “because an arrangement is made to reduce for the future the annual payments while paying a lump sum down to represent the difference”. If it is assumed that the payments of the kind in Cameron v. Prendergast and Tilley v. Wales are not made in consequence of the termination of an employment, the receipts, as ordinary usage income, will be income for purposes of the Assessment Act.

2.389 The prospect that a receipt will be held to be for giving up a contract to perform services is considerably diminished, if not extinguished, if the payment is provided for in the contract to perform services. A contract of service may provide that if services are terminated for any reason the taxpayer will receive an amount “as compensation for the surrender of his rights under the agreement”. A number of United Kingdom authorities support the view that the receipt is further compensation for services, more especially where the amount is calculated by reference to the period for which services have already been performed and the rate of reward for those services. Henry v. Foster (1932) 16 T.C. 605 is the leading case. It was applied by the Court of Appeal in Dale v. de Soissons (1950) 2 All E.R. 460, in circumstances where the amount was calculated by reference to the period of services still to run under the service agreement at the time of the termination. Dale v. de Soissons comes near to asserting a proposition that a receipt stipulated for in a contract of service can never be a receipt for the surrender of rights under the contract. The receipt is in satisfaction of a contractual right, not for the surrender of contractual rights.

2.390 Payments of the kind in Henry v. Foster and Dale v. de Soissons would appear to be payments made “in consequence of termination of an employment of the taxpayer” and thus subject to tax, not as ordinary usage income, but under the provisions of SS 27B and 27C.

2.391 In Bennett (1947) 75 C.L.R. 480 the taxpayer continued to render services under a new agreement entered into on the same day as the agreement cancelling the former agreement. The agreement to cancel the
former agreement provided for payments to be made to the taxpayer. These payments, under the new agreement, were refundable by him if he exercised options to extend the period of his service under the new agreement. Williams J. declined to hold that the payments were remuneration for his services under the new agreement. He relied on the provision in the new agreement for refunds if the options were exercised, and on the fact that under the new agreement the taxpayer did not have the position of control of the company's business that he enjoyed under the former agreement. The emphasis given to the new agreement, an agreement independent of the cancellation agreement, is a rejection of a view that the form of the cancellation agreement is paramount. If it be assumed that a payment of the kind received in *Bennett* is not a payment in consequence of termination of an employment of the taxpayer, it will not be income under s. 27B or s. 27C. It will thus not be income on any ground. Surrender of rights as an act done in carrying on a business

2.392 If an agreement to perform services is a revenue asset of a business, or a non-structural asset of an activity of providing services, an amount received for surrendering rights under the agreement will be income, not as a reward for services, but as a gain from an act done in carrying on a business, or in carrying on the activity of performing services. The notion of an activity of performing services distinct from a business of providing services is necessary to accommodate the decision in *Brent* (1971) 125 C.L.R. 418 discussed in [2.375] above.

2.393 Where the taxpayer, most likely a full-time employee, has rights under only one contract to provide services as an employee, it is hard to conceive that he could be held to have a business of rendering services, and the question whether the contract is a revenue asset does not arise. There is, none the less an assumption in this observation that an agreement to render services as an employee may in some circumstances be an asset of a business. This might be thought to conflict with the definition of a “business” in s. 6 of the Act, which excludes occupation as an employee. The definition in s. 6 does not, however, have any relevance to principles stated in describing the ordinary usage meaning of income.

2.394 Where a taxpayer as an employee has rights under several contracts to provide services to different employers, a conclusion that he is in business providing services and that an individual contract is a revenue asset of that business is possible. It may be more likely if he has entered into agreements as a self-employed person as well as an employee. In *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144 Starke J. concluded that the taxpayer was in business providing services as an employee, and that the particular contract with which the case was concerned was a revenue asset
of that business. The receipts for surrender of those rights were income. The case is curious in that it was assumed by all members of the court (Dixon, Evatt, Starke JJ.) that the taxpayer was in business in partnership with his brother. There may be some difficulty in regarding an agreement to serve as an employee as an agreement entered into in carrying on business in common with another. If it can be so regarded the opportunities for income splitting through partnerships would be increased many fold.

2.395 The possibility remains that the contract to provide services as an employee, though not a revenue asset of a business, is a non-structural asset of an activity of providing services. The possibility is raised in [2.385] above in relation to the decision in Maddalena (1971) 45 A.L.J.R. 426. An amount for surrendering rights under such an agreement will be income within the ordinary usage notion of income.

2.396 Where the payment on the surrender of rights under the agreement to provide services as an employee is made in consequence of termination within the meaning of those words in the definition of “eligible termination payment” in s. 27A(1), the question whether there is ordinary usage income arising from the surrender will not be significant. The receipt will be income under s. 27B or s. 27C, and the operation of ordinary usage principles will be excluded. In C. of T. (Vic.) v. Phillips there were several payments and this might take them out of the definition of “eligible termination payment” as “an annuity . . . to which s. 27H applies”. Dixon and Evatt JJ. seemed persuaded that the receipts were periodical receipts within the ordinary usage principle. Ordinary usage may none the less be excluded by a conclusion that s. 27H is a code. The matter was considered in [2.223] above.

2.397 Where the taxpayer as a self-employed person has rights under only one agreement to provide services, it is arguable that he has no business. It would be relevant to ask whether he has commercial capacity to enter into other agreements—he may have agreed not to perform services for persons other than the other party to the agreement. In any case, where there is only one agreement a conclusion is to be expected that the agreement is not a revenue but a structural asset of the business.

2.398 Where a self-employed person enters into contracts to provide services to a number of persons, each contract of service will generally be a revenue asset of a business, and a gain from surrendering rights under the contract will be income. The electrician's contracts considered in Maddalena (1971) 45 A.L.J.R. 426 at 427 are revenue assets. It may be, however, that a particular contract gives rise to a very substantial part of the taxpayer's business activity, such that it is to be regarded as a structural asset of his business, and a gain from surrendering rights under that
contract will not be ordinary usage income.

2.399 Where there is no business, the possibility must again be considered that the contract is a non-structural asset of an activity of rendering services. A receipt for surrendering rights under such a contract would, presumably, be income within the ordinary usage notion.

2.400 Where the payment on the surrender of rights is made in consequence of termination of an “office” within the meaning of that word in the definition of “eligible termination payment” in s. 27A(1), imported by the definition of “employment” in s. 27A(1), the question whether there is ordinary usage income arising from surrender will not be significant. The receipt will be income under s. 27B or s. 27C, and the operation of ordinary usage principles will be excluded. The meaning of “office” in this connection is considered in [4.151] below.

2.401 There are a number of cases concerned with giving up agency agreements. A taxpayer who has exclusive rights under an agreement to sell the products of a manufacturer in a particular area may receive an amount for giving up rights under that agreement. The case will be a reward-for-services case only where the taxpayer sells on commission as distinct from buys and sells as principal, which may afford another illustration of the technicality of the distinction between the supply of services and the supply of property. The “agent” who buys and sells does not supply services: Cooke and Sherden (1980) 80 A.T.C. 4140. The United Kingdom authorities have adopted tests for determining whether the agency agreement is a revenue asset. These tests are essentially mathematical, taking into account the period of the agency agreement still to run at the time of the surrender and the proportion which business under the agreement is of total business done by the taxpayer. Some of the leading cases are Kelsall Parsons & Co. v. I.R.C. (1938) 21 T.C. 608 and Barr, Crombie & Co. v. I.R.C. (1945) 26 T.C. 406. In some instances, for example Wiseburgh v. Domville [1956] 1 W.L.R. 312, the importance of the agency agreement to the goodwill of the taxpayer's business is recognised. It will be important if the taxpayer's customers are customers specifically for goods of the manufacturer for whom he is agent. The significance of goodwill associated with the agency was the subject of some comment in I.R.C. v. Fleming & Co. (1951) 33 T.C. 57. Lord President Cooper drew attention to the fact that by the surrender agreement the major part of the consideration was attributed to the surrender and only a small part to a restrictive covenant given by the taxpayer. Having regard to the fact that suppliers of explosives are few, and that the taxpayer's principal, Imperial Chemical Industries, proposed to distribute its products in Scotland itself, it might have been thought that the taxpayer's goodwill
was given up by surrender of the agency and not by the restrictive covenant. It is a curious manifestation of a form approach that the taxpayer was held to be defeated by the attribution of consideration in the agreement. What he received for surrender of the agency was income. He might have arranged for a greater amount to be attributed to the restrictive covenant, and that amount would not have been income.

2.402 *Sabine v. Lookers Ltd* (1958) 38 T.C. 120 is a recognition of the element of goodwill bound up with an agency agreement when it relates to motorcars of a particular manufacture.

2.403 There is a question of how the test of significance of the agency agreement, in terms of proportion of business under the agreement to the business activity as a whole, is to be applied. It may be asked whether all business activities are relevant or only those which are, in some sense, of the same kind as that with which the surrendered agreement was concerned. What is the business activity as a whole where the agreement surrendered is one of a number of agency agreements and the taxpayer also operates a foundry? The question was raised by the facts in *Fleming v. Bellow Machine Co. Ltd* [1965] 1 W.L.R. 873, but by agreement between counsel was put aside.

2.404 Any test of a revenue asset which depends for its operation on the relative importance of that asset, whether in terms of the amount of business activity it generates or the amount of goodwill bound up with it, offers scope for planning which relies on the multiplication of taxpayers by setting up companies and distributing business activity among them. In this connection *Californian Oil Products Ltd* (In liquidation) (1934) 52 C.L.R. 28 is instructive. A receipt on surrender of rights to perform services as compensation for rewards for services

2.405 There may not be a business of which the agreement to render services is an asset, or, if there is a business, the agreement may be a structural asset of that business. Yet in some circumstances the principle expressed in Proposition 15 will operate to make a receipt for the surrender of rights under the agreement an income receipt. The receipt may be regarded as compensation for the rewards that would have been received as income if the agreement had not been terminated. The most likely circumstances in which the principle will operate involve a series of receipts. Some of the significance of receipts in a series has already been explored in relation to the periodicity principle (Proposition 11), and the gains from the property principle (Proposition 12). The significance of receipts in a series now noted lies in attracting the operation of the compensation principle (Proposition 15).

2.406 The leading case, where there is a surrender of rights, is *C. of T.*
Vic. v. Phillips (1936) 55 C.L.R. 144. The case concerned a contract to manage a theatre as an employee. The surrender was for a series of receipts calculated so as to approximate the salary receipts that would have flowed to the taxpayer from the agreement terminated, the payment of each amount being made at the time a salary payment would have been made. Starke J., it has already been noted, gave as a ground for holding that the receipts were income that they were in respect of the surrender of rights which constituted a revenue asset. It has also been noted that Dixon and Evatt JJ. considered that the receipts were an annuity, the “fixed gross sum” being only the arithmetical sum of the series of receipts. All members of the court gave the compensation receipts principle as a further ground that the receipts were income. The value of an asset, an economist might say, is simply the present value of the expected flows of income the asset will produce. To say that a present receipt of that value is compensation for those income flows would be to allow the compensation receipts principle to ravish much of the other established principles of income tax law. But there is a place for the operation of the compensation receipts principle when a receipt corresponds in time and amount with an income flow.

2.407 There is of course a question of the degree of correspondence that is necessary to attract the principle. Phillips involves a near complete correspondence. Some of the judgments in Dickenson (1958) 98 C.L.R. 460 which concerned the giving up of capacity to conduct business operations refer to Phillips and contemplate that a series of receipts might have attracted the compensation receipts principle. But any close examination of the degree of correspondence required was not undertaken. Nor is it undertaken in any other case.

2.408 Where the taxpayer is an employee, as he was in Phillips, or the holder of an office, there is a prospect that any receipt is an “eligible termination payment” as defined in s. 27A(1) so that the operation of ss 27B and 27C are attracted. It will be such if it can be said to be a payment made “in consequence of the termination of any employment [or the holding of an office] of the taxpayer” and it is not within one of the exceptions listed in the definition. If ss 27B and 27C apply the question whether any receipt is income by ordinary usage becomes irrelevant. Where the receipt is one of a series as in Phillips the receipt may be excluded from the definition of “eligible termination payment” by the exception “of an annuity, or supplement, to which s. 27H applies”. In which event the question raised in [2.223] above as to whether s. 27H can be seen as a code excluding the ordinary usage notion of income is raised.

Receipt for accepting a restriction on one's capacity to perform services
2.409 It is assumed in the cases that a receipt for accepting a restriction on one's capacity to perform services is not a reward for services. The cases for the most part are concerned with restrictive covenants, and the question is whether the receipt should be regarded as being for the restriction or for the performance of services under some associated agreement to serve. There is, however, a reference in the judgment of Harman J. in *Higgs v. Olivier* [1951] Ch. 899 at 901 to a suggestion by the Crown that not performing services, because of an undertaking given to another which restricts the performance of services, is itself a service, and the receipt for accepting the restriction is a reward for that service:

“The Crown had to face the fact that the agreement . . . was an agreement not to act, and their answer was that money might be made by refraining just as by ceasing to refrain, and that this was an incident in the career of a popular actor by which he exploited his personality, just as he might have exploited it in the opposite way, by acting.”

2.410 In *Jarrold v. Boustead* [1964] 1 W.L.R. 1357 the taxpayer, who had until then been an amateur footballer, agreed to play professional football for a club. Under the same agreement he received an amount “on signing professional forms”. The Court of Appeal held that this amount was for the permanent loss of his freedom to play sport as an amateur, which resulted from his becoming a professional. In the later case of *Riley v. Coglan* [1967] 1 W.L.R. 1300 an amount, also expressed to be payable “on signing professional forms” was held by Ungoed-Thomas J. to be a reward in advance for playing football for the club. Part of the amount was repayable to the Club if the taxpayer failed to carry out his agreement to play for the club. *Woite* 82 A.T.C. 4578 contrasts with *Riley v. Coglan*. In *Woite* the taxpayer did not enter into a contract to play football for the club making the payment to him. He played football in South Australia, and continued at all relevant times to do so. He entered into a restrictive covenant not to play football for any football club in Victoria except the club making the payment to him. A characterisation as a reward for services was therefore not open, except on the analysis referred to in the judgment of Harman J. in *Higgs v. Olivier* [1951] Ch. 899 at 901. Mitchell J., in holding that the receipt was not income, did not consider that possible analysis. *Pritchard v. Arundale* [1972] 1 Ch. 229 involved a receipt by a solicitor of a number of shares “in consideration of” his “undertaking to serve” a company full-time as a joint managing director. Megarry J. held that the receipt was not a reward for services to be performed in the office, but for giving up his practice as a solicitor. He expressed the view that in characterising the receipt the terms of the agreement were entitled to be given full weight, but
only as part of the surrounding circumstances. The case may thus be seen as concerned with the substance of the rule that a receipt for accepting a restriction on one's capacity to perform services is not a reward for services.  

2.411 Pritchard v. Arundale [1972] 1 Ch. 229 bears some comparison with Moriarty v. Evans Medical Supplies [1958] 1 W.L.R. 66 and, among Australian cases, with Dickenson (1958) 98 C.L.R. 460. In Evans Medical Supplies the receipt was expressed to be for the giving of information to the Burmese Government about the manufacture of certain drugs used in veterinary medicine. None the less, it was held that the receipt was not a reward for this service, but for the loss of the taxpayer company's trade in Burma, a loss which could be predicted as a commercial consequence of equipping the Burmese Government with the know-how, so that it might itself manufacture the drugs. The case might be thought to be a model illustration of characterising by reference to all the circumstances, and a consequent neutralisation, if not contradiction, of the terms of the agreement under which the amount was received. The receipts in Dickenson were expressly linked with the giving of restrictive covenants. The High Court's characterisation was consistent with those links. It was, none the less, made by reference to all the circumstances. Kitto J. observed (at 493): “[The amounts] were really payable in connection with the whole machinery by which the desired tie to the Shell Company was accomplished, and not with any one part of that machinery considered by itself.”  

2.412 A number of United Kingdom cases are concerned with the characterising of receipts expressed to be for covenants entered into by employees restricting rights to perform services for others. In both Beak v. Robson [1943] A.C. 352 and Higgs v. Olivier [1952] Ch. 311 (Court of Appeal) the receipt was held to be for the restriction. In neither case, however, was the form of the agreement under which the payment was made treated as definitive. The circumstance that the restriction, though provided for in the service agreement, commenced on the termination of the service agreement was regarded as important in making the characterisation in Beak v. Robson. In Higgs v. Olivier Evershed M.R. expressed a view that a receipt in respect of a restriction to run during service is the more likely to be regarded as a reward for services. Higgs v. Olivier involved a payment expressed to be for a restriction commencing after the completion of services. Where a restrictive covenant is provided for in the service agreement and the covenant is to run during service, a conclusion that the amount of the consideration attributed to the covenant is a reward for services is near inescapable. Where the law would imply a
covenant not to work for others during the currency of the agreement, the taxpayer's promise in the restrictive covenant is a promise to do what he is in any case bound to do in serving his employer.

2.413 The conclusion in *Beak v. Robson* [1943] A.C. 352 that a payment for a restrictive covenant to run from the termination of a service agreement and provided for in the agreement, may be held not to be income, raises the prospect that part of the consideration described as salary in a service agreement that provides for a restrictive covenant but does not attribute any consideration to the covenant, is not income. The Revenue argued in *Beak v. Robson* that the taxpayer's case required a logical inference that salary receipts would need to be apportioned between reward for services, which would be income, and consideration for the restrictive covenant which would not. The inference in Australia, beset by the principle in *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341 considered in [2.558]ff. below, may be that no part of the salary receipts is income because the income element cannot be dissected or apportioned from them.

2.414 The validity of a restrictive covenant may be affected by common law principles and trade practices legislation. The fact that a restrictive covenant is not enforceable in its terms will bear on the issue whether the consideration attributed to the restrictive covenant should be seen as a receipt for services, or a receipt for accepting a restriction on capacity to perform services. But it does not dictate a conclusion. A receipt for undertaking an obligation that the taxpayer regards as binding on him may be a receipt for accepting a restriction on his capacity to perform services, notwithstanding that the obligation cannot be enforced against him. Observations in *Dickenson* (1958) 98 C.L.R. 460 are sufficient authority: per Williams J. at 481-2; per Kitto J. at 490.

2.415 The possibility that a receipt for accepting a restriction on one's capacity to perform services is an “eligible termination payment” within the definition in s. 27A(1), and is thus subject to ss 27B and 27C is considered in [4.138]ff., especially [4.182] below.

2.416 There is no Australian judicial decision concerned with a restrictive covenant limiting a taxpayer's capacity to perform services. Accepting a restriction on capacity to render services as an act done in carrying on a business

2.417 A conclusion that a receipt is not a reward for services, but is a receipt for a restriction on capacity to render services, does not necessarily mean that the receipt is not income. It may be income as a gain from an act done in carrying on a business. The accepting of restrictions may conceivably be a business in itself. More likely, it may be held to be
incidental to some other business activity. In *Higgs v. Olivier* [1952] Ch. 311 at 315 there is a recognition of the possibility that the giving of a covenant not to perform, for a period, in any film or play might be regarded as “in the ordinary run of the profession or vocation of actors”, though the covenant in the facts of the case was of an unusual character and could not be so regarded. *Dickenson* was concerned with the first occasion on which the taxpayer had entered into a tie by which he agreed to sell only a particular oil company's product. The system of ties between garage proprietor and oil companies was in course of being established. Dixon C.J. remarked that receiving an amount for a tie in these circumstances was not a normal or natural incident of carrying on business as a garage proprietor. The possibility cannot be excluded that in modern conditions when entering into a tie agreement is a universal experience in the business of a garage proprietor, receiving an amount for a tie is incidental to carrying on that business. The capacity to accept a restriction is, in effect, a revenue asset. A receipt, on accepting a restriction, as compensation for rewards for services

2.418 In some circumstances the principle expressed in Proposition 15 will operate to make a receipt for accepting a restriction an income receipt. Where the receipt is one of a series it may be regarded as compensation for an income flow which might have been received if the restriction had not been accepted. *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144 and *Dickenson* (1958) 98 C.L.R. 460 in this regard, are considered above in [2.405]-[2.408]. The operation of Subdivision AA

2.419 Where a restrictive covenant is entered into while service by an employee continues, it is unlikely that the payment for the covenant could be said to be a receipt by the taxpayer “in consequence of the termination of [an] employment”. The payment may be in contemplation of termination, but it is hardly in consequence. Sections 27B and 27C will thus not displace the operation of ordinary usage principles. Where the payment is made on termination and admits of the description as a payment in consequence of the termination of the taxpayer's employment, ss 27B and 27C may still not be operative. Paragraph (m) of the definition of “eligible termination payment” in s. 27A(1), excludes “consideration of a capital nature for, or in respect of, a legally enforceable contract in restraint of trade by the taxpayer, to the extent to which the amount or value of the consideration is, in the opinion of the Commissioner, reasonable having regard to the nature and extent of the restraint”. Where the payment would be income of the taxpayer as a reward for services, para. (m) can have no application. The receipt by the taxpayer is not of a capital nature. It may then be within the definition of eligible termination payment and subject to
s. 27B and s. 27C.

Form and substance

2.420 In the discussion of the problems of characterising a receipt as a reward for services or as a receipt for surrender of rights, and of the problem of characterising a receipt as reward for services or as a receipt for accepting a restriction, some observations were made on the significance that may be accorded to form. Generally the form of the agreement has been regarded as merely one fact that may be relevant in determining the characterisation, though the doctrine of form in *I.R.C. v. Duke of Westminster* [1936] A.C. 1 has not gone unnoticed. In *I.R.C. v. Fleming & Co.* (1951) 33 T.C. 57, the allocation in the agreement of an amount as being for the surrender of contractual rights, when it might have been allocated to a restrictive covenant, was thought to require the operation of form to the disadvantage of the taxpayer.

2.421 There would appear to be no role for the *Duke of Westminster* doctrine of form in this context. The doctrine remains part of United Kingdom law, though it has been explained recently in a way that may make it less of a support in tax planning than formerly: *W. T. Ramsay Ltd v. I.R.C.* [1982] A.C. 300; *I.R.C. v. Burmah Oil Co.* (1982) S.T.C. 30; *Furniss v. Dawson* [1984] 2 W.L.R. 226. The doctrine continues to be applied in the High Court: *Westraders* (1979) 144 C.L.R. 55. But its role should be confined to the context of a specific statutory provision which attaches tax consequences to the adoption of a legal form. The doctrine does no more than say that a taxpayer, who has, in a transaction which is not a sham, adopted that legal form, is benefited or burdened by those tax consequences. The question in *Duke of Westminster* was whether the payment was an “annuity or . . . annual payment . . . payable wholly out of profits or gains brought into charge”. There was room for debate about the meaning of the words “any annuity or annual payment”, but if the taxpayer's actions were within that meaning he was entitled to the tax consequences. Where the context is the ordinary usage meaning of income and the only relevant statutory provision is the word “income” itself in s. 25, there is no role for the *Duke of Westminster* doctrine. The question is whether the facts come within some rather vague notions which the courts have sought to express in principles and rules. A formulation in a judgment of a court of a rule that a receipt for a restrictive covenant is not income as a reward for services, is very different from a specific provision in the Assessment Act. In this context a conclusion that the receipt was not “really” or “in substance” for the restrictive covenant, though it was such
in form, involves an assertion that the idea of receipt for a restrictive covenant expressed in the rule transcends the legal forms that have been used in expressing it. That idea may require reference to the intentions of the parties: could it have been expected that the taxpayer would have received the amount in any event, under the form of a payment for services, if he had not entered into the restrictive covenant? Reference to these intentions may require a conclusion that the “substance” of the transaction was a reward for services, or, which amounts to the same thing, that the transaction was within the substance of the principle that a reward for services is income. Tax law which is made to operate mechanically through legal forms must invite defeat of any principles it may seek to express.

2.422 The doctrine of form is as irrelevant in the characterising of a receipt as income within the ordinary usage notion of income as it is in the characterising of an outgoing as deductible under the general deduction provision in s. 51. The chaos that has resulted from importing the doctrine of form into that context is considered at length in Chapter 9, [9.17] below. Thus a rule that interest on money borrowed to invest in income producing property is deductible may be a useful judge made rule expressing the broad principle in s. 51. But to treat a payment which is in form interest on such money as deductible simply because it has that form, is to mechanise the tax system and confound principle.

2.423 A distinction may be drawn between a doctrine of primary form and a doctrine of secondary form. Primary form concerns only those provisions of the Assessment Act that attribute tax consequences to actions which are within specific words that have a definitive legal meaning. Thus the courts have found a definitive meaning for the word “royalties” and a taxpayer who enters a transaction of the kind adopted by the taxpayer in McCauley (1944) 69 C.L.R. 235 must accept the consequence that he derives income, though the adoption of another transaction which followed the precedent of Stanton (1955) 92 C.L.R. 630 might have enabled him to avoid that consequence. A taxpayer whose transaction fits the words of legal art in the phrase “subscriptions for shares” in a mining company is entitled to the deduction that the law may give for such a subscription. The doctrine of primary form will support him. Mullens (1976) 135 C.L.R. 290, a case mentioned again in Chapter 16, involved an attempt by the Commissioner to overcome the primary form doctrine by resort to the general provisions of s. 260 (now displaced by Pt IVA), in circumstances of a subscription for shares. There are those who would say that the primary form doctrine should prevail over any attempt to defeat it by reference to a policy of the Act, whether by a direct application of a policy or by means of a general
anti-avoidance provision. Values expressed in the phrase “the rule of law” are at stake. The matter is considered again in Chapter 16.

2.424 A doctrine of secondary form ought not to attract the same support. Such a doctrine concerns, not definitive words of the Assessment Act, but definitive words that may have been adopted in judicial interpretation in expressing a broad principle reflected in words of the Act that are not in themselves definitive. That interpretation will most often have concentrated on the ordinary usage concept of income that is attracted by the word “income” in s. 25(1), and the broad concept of deductibility expressed in the words “incurred in gaining” in s. 51(1).

2.425 Most often judicial interpretation of broad concepts will not have come to be settled in rules expressed in definitive words, though there is a constant demand for interpretation that is expressed in definitive words. And there is generally enough flexibility in judicial precedent to recommit any rule to a new formulation. There are, however, illustrations in judicial decisions of the assertion of rules in definitive words which will dictate a result that may be thought to be in conflict with a due regard for the broad concept. Most commonly the rule is expressed in terms of the basic elements of contract law. Thus the rule may say that a receipt that is the consideration for a restrictive covenant and creates a binding obligation to observe the restriction does not have an income character. A rule of this kind will explain the observation of Lord Cooper in *I.R.C. v. Fleming & Co. Ltd* (1951) 33 T.C. 57 that to the extent that the receipt by the taxpayer had been in the contract attributed to the restrictive covenant it would not have been income. It would not have mattered that in all the circumstances the receipt was not, in a broad judgment of its links with the covenant, for the covenant. Extended form would thus prevail over the broad concept of income. The extended form approach evident in *Fleming* contrasts with the approach taken by Megarry J. in *Pritchard v. Arundale* [1972] 1 Ch. 229. The contract may have identified the receipt as the consideration for a promise by the taxpayer to provide services to a company. But in all the circumstances Megarry J. judged the receipt to be for the giving up of his professional practice in order to be free to undertake the provision of services as managing director of the company. Megarry J. expressly rejected an extended form approach, at the same time denying that there was any rule that the consideration provided for in a contract to perform services was income. Any rule that expressed the concept of income would in his view need to be framed, not in terms of consideration, but in terms of a more flexible notion of cause.

2.426 Great issues of the validity of a secondary form approach to the interpretation and operation of the Assessment Act have arisen in recent
years in *Europa Oil (N.Z.) Ltd v. I.R.C. (No. 2)* (1976) 76 A.T.C. 6001 and *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645. The judgment of the Privy Council in *Europa Oil (No. 2)* is a triumph for extended form. The broad principle of s. 51 comes to be expressed in the context as a rule that the consideration given under a contract solely for the supply of trading stock is deductible. The fact that there were other purposes to be served by the making of the payment that could be inferred from all the circumstances was thus irrelevant. *South Australian Battery Makers* is a qualified triumph for extended form. The qualification is in the judgment of Gibbs J. who wanted to leave some room for the views of Dixon J. in *Hallstroms Pty Ltd* (1946) 72 C.L.R. 634 that issues as to deductibility should be approached from a practical and business point of view, rather than by reference to legal relations that arise. Those views are a rejection of extended form. The relevant rule of extended form in *South Australian Battery Makers* was that a payment that is the consideration under a lease solely for the use of the property leased is deductible. The qualification of Gibbs J. was that notwithstanding the terms of the lease, the payment might in part be denied deduction where in all the circumstances a conclusion could be reached that the payment was in part to secure some advantage to the taxpayer beyond the use of the property leased.

2.427 A doctrine of extended form merges into another doctrine that might be identified as the “blinders” doctrine. A rule may be expressed in terms that maintain the flexibility of the broad concept adopted by the Act. Thus it may be asserted that a payment which has as its purpose the acquisition of trading stock is deductible. The blinders doctrine will destroy that flexibility by insisting that whenever a transaction has been cast in a legal form—a lease, a contract or other form—the purpose of the payment must be found within the expression of the transaction in that legal form. *Europa Oil (No. 2)* can be explained in its outcome as either an application of the extended form doctrine or the blinders doctrine. Lord Wilberforce, who dissented in *Europa Oil (No. 2)*, rejected the blinders doctrine in a statement of what he saw as “familiar principles” in *W. T. Ramsay* [1982] A.C. 300 at 323: “The well-known principle in *I.R.C. v. Duke of Westminster* . . . while obliging the court to accept documents or transactions, found to be genuine, as such, . . . does not compel the court to look at a document or transaction in blinders, isolated from any context to which it properly belongs.”

2.428 The extended form doctrine may equally merge with the blinders doctrine where the issue is the character of an item as income. Thus the observation by Lord Cooper in *I.R.C. v. Fleming & Co. Ltd* (1951) 33 T.C.
57 referred to in [2.425] above could be explained as an assertion of the blinkers doctrine. Even though the relevant rule is expressed in the flexible notion of cause—that a receipt whose cause is the giving of a restrictive covenant is not income—it will yield the same result as extended form if the transaction in which the restrictive covenant is given is cast in the form of a contract by which the receipt is the consideration for the giving of a restrictive covenant.

**Proposition 14: A gain which arises from an act done in carrying on a business, or from the carrying out of an isolated business venture, has the character of income**

2.429 The word “business” used in this proposition, and in the “business gains” principle which it seeks to express, identifies a notion which is part of the ordinary usage meaning of income. That notion is not necessarily described expressly in the definition of “business” in s. 6 of the Assessment Act, or by implication in other provisions which use the word business and attract, prima facie, that definition. The definition in s. 6 excludes “occupation as an employee” with the consequence, there being no contrary intention, that the so-called second limb of s. 51 does not apply to an employee seeking a deduction of employment expenses. In the outcome the definition has offered some basis for distinguishing between a self-employed person who provides services, and an employed person who provides services, and for discriminating against the latter in the allowing of deductions of expenses. Where, however, the question is whether there is a business of performing services of which a contract is a revenue asset, the fact that the contract is an employment contract does not preclude a conclusion that there is a business. The matter was the subject of some comment in [2.394] above.

2.430 The notion of business in the ordinary usage principle will embrace activities which, in a status-conscious use of words, would be described as a profession.

2.431 There is a distinction to be drawn between a continuing business and what is referred to in Proposition 14 as an isolated business venture. The distinction is drawn within the ordinary usage business gains principle. And both continuing business and isolated business venture have, it seems, operations that exclude the operation of the specific provisions of s. 25A(1) (formerly s. 26(a)) and s. 52. Clearly the notion of a continuing business must exclude the specific provisions of s. 25A(1) and s. 52. In *Investment & Merchant Finance Corp. Ltd* (1971) 125 C.L.R. 249, Barwick C.J. observed that these provisions deal with transactions which are entire in
themselves, and do not form part of a more extensive business. The sections in the result have no application in circumstances where the trading stock provisions (Subdiv. B of Div. 2 of Pt III) of the Act apply, provisions which, it is assumed, apply only in continuing business situations. If s. 25A(1) and s. 52 did apply in continuing business situations, there would be irreconcilable conflicts with the trading stock provisions. More recent authority, in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355, may require a conclusion that an “isolated business venture” as an aspect of the ordinary usage meaning of income has an operation that excludes the operation of s. 25A(1) and s. 52. The relationship between the notion of an isolated business venture and s. 25A(1) is examined in [3.4]ff. below. Observations in *Whitfords Beach* indicate that s. 25A(1) can only operate where the notion of an isolated business venture is not satisfied. There is no overlap in this respect between ordinary usage and the specific provisions.

2.432 The notion of a continuing business involves a pattern of transactions, and an appraisal of that pattern as distinct from an appraisal of each transaction as if it stood alone. Thus a taxpayer may have a continuing business of buying and selling land. In the carrying on of that business he sells other land which he may have inherited. The sale of the inherited land will generate gains which are income, though the transaction of selling the inherited land, if it stood alone, would not have been an isolated business venture or a transaction within s. 25A(1). A conclusion that there was an isolated business venture or a transaction within s. 25A(1) might have been excluded by the “advantageous realisation” doctrine considered in [2.501] and [3.68] below.

2.433 The law reports are peppered with statements as to what may be a “business”. The statements give significance to a variety of factors, but offer very little in the way of determinate rule: no factor is said to be necessary, and no combination of factors conclusive. One statement collects other statements, which may have been made in a different context. Where the question is whether there is a continuing business within ordinary usage principles, statements about the meaning of the word “business” in relation to an isolated business venture, or as used in some specific provision in the Assessment Act or in some other taxing Act, or indeed in an Act not concerned with tax, are of limited relevance.

2.434 The United Kingdom Royal Commission on the Taxation of Profits and Income sought to state the “badges of trade” for purposes of the United Kingdom income tax: *Final Report* (1955, Cmnd 9474, p. 39). Its statement has been frequently quoted without a recognition of the fact that the Commission was not seeking to distinguish in the language of the
United Kingdom statute, between continuing “trade” and an “adventure in the nature of trade”. A statement that is wide enough to describe continuing business and isolated business venture will offer very little in the way of determinate rule. The system that will give the character of business to continuing activity is necessarily different from the system that will give the character of business to an isolated business venture. In the case of a continuing business the system is to be found in the factors that link the transactions, none of which is in itself necessarily a business. In the case of an isolated business venture the system must be found in the transaction itself.

2.435 If the absence of determinate rules is exasperating, there may be some comfort in realising that it is, to a degree, inevitable. Where the realisation of property is involved, the issue of business or no-business is the issue of income gain or capital gain. In policy terms, a conclusion that there is a business will equate the tax treatment of a person who makes gains from the realisation of property with a person who makes gains from performing services. A conclusion that there is not a business will encourage an investor by giving him immunity from income tax on any gain from the realisation of his investment. This immunity—it can be seen as a tax subsidy—jars with another policy which would say that gains which arise without effort should not only be taxed, but taxed more than others because the taxpayer derives his gain without sacrifice of leisure. This other policy finds expression in some tax systems in a surcharge on property income. Strangely, in those systems capital gains continue to be at least favourably treated. The confusion of conflicting policies must be reflected in the law.

2.436 Australia has twice dallied with a surcharge on property income, and once came close to taxing capital gains. It has pushed the meaning of income some degree into the field regarded by ordinary usage as capital gain. This has been done by s. 26(a) (now s. 25A(1)) and s. 26AAA in ways considered in Chapter 3. But the issue of business or no business remains the battle ground of policies.

Continuing business

2.437 It is not proposed to gather a further collection of statements about the meaning of business. The present concern is, in any case, only with the notion of continuing business. And any collection of statements would quarrel with any new statement of the kind now attempted that seeks even a modest degree of determinateness.

2.438 A continuing business involves a number of transactions which are
repetitive and systematic and are overall moved by a purpose to profit. If authority is necessary it may be found in *Martin* (1953) 90 C.L.R. 470, so far as the elements of number, repetition and system are concerned, and in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106, so far as the overall purpose to profit is concerned, though the case may leave some doubts as to what gains are profit in this context.

**A number of transactions**

2.439 In the joint judgment of Williams A.C.J., Kitto and Taylor JJ. in *Martin* it is said (at 479):

“The onus . . . is on the appellant to satisfy the court that the extent to which he indulged in betting and racing and breeding racehorses was not so considerable and systematic and organised that it could be said to exceed the activities of a keen follower of the turf and amount to the carrying on of a business.”

Later cases have lessened the emphasis on the size of the operations. Indeed the first transaction, if a number are contemplated which will be of the same kind and systematic, may be regarded as a transaction of a continuing business. *Fairway Estates Pty Ltd* (1970) 123 C.L.R. 153 concerned with a business of money lending, is authority. Cases which lessen the emphasis on the size of the operations in the passage quoted from *Martin* are *Thomas* (1972) 46 A.L.J.R. 397, *Ferguson* (1979) 79 A.T.C. 4261 and *Mullins* (1981) 81 A.T.C. 4192. In each of the latter three cases it was the taxpayer who was asserting that there was a continuing business—in each case a primary production business—in order that he might have a deduction for expenses which exceeded any gains. It may be easier to find the elements of repetition and system where animals are husbanded, or land is made to produce a crop. In other circumstances, for example selling the land itself or a static product of land such as blue metal, or selling goods or shares, or horseracing and gambling as in *Martin*, the size of the operations will be more important in establishing repetition and system.

2.440 The Commissioner's argument in *Ferguson* was that the taxpayer's actions were only preliminary. He was acquiring cattle under an arrangement by which he was entitled to the progeny of leased cattle agisted on another's land under a management agreement. He sold the bull calves, and retained the heifers to stock land of his own he would ultimately acquire. Cases considered in Chapter 5 of this Volume indicate that there may be activity which is prior to commencement of a business and which is not part of that business. It is not easy to see how the acquisition of stock could be activity of such a kind. The Federal Court concluded that the activity was activity of a preliminary business, which may be thought an unnecessary complexity. There will be accounting problems when the preliminary business ends, and the permanent business commences, involving the possible operation of s. 36 and the principle in *Sharkey v. Wernher* [1956] A.C. 58 considered in Chapter 14.
2.441 A continuing business must in the logic of the notion commence with a single transaction. The point is recognised in the judgment of Barwick C.J. in *Fairway Estates* (1970) 70 A.T.C. 4061. There must be a first lending by someone whose continuing activities require a conclusion that he is engaged in a business of money lending. Its character as a transaction of a continuing business is the result of inferences to be drawn from later activity in which the elements of number of transactions and system and organisation come to be satisfied. It may be that the first transaction is in fact the only transaction, the taxpayer having died thereafter or abandoned an intention to proceed. It is unlikely that the circumstances of a single transaction will yield inferences of intention to engage in repetitive transactions and of system and organisation, though it is not impossible. If the circumstances of a single transaction do not yield the necessary inferences, the subjective purpose of the taxpayer may assist him. At least this would be an appropriate extension of the decisions in *Ferguson* (1979) 79 A.T.C. 4261 and *Mullins* (1981) 81 A.T.C. 4192.

2.442 *Southern Estates Pty Ltd* (1967) 117 C.L.R. 481 involved a question whether there can be a business even though the repetitive transactions from which profits will directly flow have not yet commenced. The taxpayer was engaged in clearing land that might thereafter be used in a business of cattle raising and sale. He sought deductions only available to a taxpayer “engaged in a business of primary production”. The judgment in *Southern Estates* involved a variety of views. In one view, identified as the view of Barwick C.J., it would be enough to give the clearing activity a character of business activity that the taxpayer already engaged on other land, whether or not adjoining, in cattle raising and sale. Another view, identified as the view of Windeyer J., was that an inference of purpose, or a subjective purpose, to engage in cattle raising and sale on the land when cleared will be enough to give a business character to the clearing activity. The view of Windeyer J. would justify a conclusion that the taxpayer is in business though he does not as yet engage in cattle raising and sale on any land. And it justifies a conclusion that whatever are his activities on other land he will not be held to be in business in relation to the clearing operations if the inference of purpose, or his subjective purpose, show that he intended to sell the land immediately it was cleared. Which is not to say that the clearing and sale may not be an isolated business venture. It will more likely be so if the land has been acquired for the purpose of clearing and sale. And there will be questions of the interrelations between isolated business venture and s. 25A(1), a matter explored in [3.4]ff. below.

2.443 A business may continue though repetitive activity is not presently evident. *AGC (Advances) Ltd* (1975) 132 C.L.R. 175 is authority that a
business may be “suspended”. There must, however, be an inference to be drawn, or, perhaps, a subjective purpose, that the activity will be resumed. Otherwise the notion of cessation would be deprived of meaning.

**Profit purpose**

2.444 The relevant purpose is an overall profit purpose. It is different when the issue is the existence of an isolated business venture, where there must be a profit purpose in the particular transaction. There is a distinction between a profit purpose and a profit motivation. It is not necessary that the taxpayer be motivated by a desire to profit. United Kingdom authorities holding that religious societies, a law society publishing law reports, and public utilities are in business do not reject a requirement of profit purpose. Realising a surplus so as to establish and maintain a reserve is a profit purpose. Where however prices are deliberately pitched so as to subsidise persons who buy the goods or services provided by the taxpayer, there is no business.

2.445 The authority for the requirement of profit purpose given above was *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106. Other authority is *Thomas* (1972) 46 A.L.J.R. 397 at 401 where Walsh J. held the growing of pine trees not to be a business because it lacked a “significant commercial purpose or character”. A more guarded observation was made by Fisher J. in *Ferguson* (1979) 79 A.T.C. 4261 at 4270:

“[I]t is certainly relevant to ascertain if the operations of the taxpayer have a commercial purpose, i.e. pursuit of profit or gain rather than pleasure or recreation.”

2.446 In most of the cases in courts, it is the taxpayer who is asserting the existence of a business. It has been noted that *Thomas, Ferguson* and *Mullins* (1981) 81 A.T.C. 4192 are such cases, and there are many others. The taxpayer seeks to establish a loss, in the sense of deductible expenses exceeding gains from the alleged business, a loss that he may deduct against other income. The Commissioner's view is likely to be that the activities amount only to a “hobby” and not to a “business”. Implicit in this is an assertion that there was no overall profit purpose.

2.447 The authorities on profit purpose suggest that it is enough that an objective inference of profit purpose can be drawn. One basis of inference will be the size of the activities on which the taxpayer is engaged. In this connection size of operations has significance, in addition to any significance it may have in regard to repetition and system. In *Ferguson* Fisher J. said (at 4269):

“[T]he conclusion is open to be drawn that a taxpayer is engaged in business
activities notwithstanding the fact that he is operating in a very small way i.e. on a few acres, with very few trees or with a very small number of stock. I would be of opinion that the size of the operation could be of significance for the purpose of testing whether a taxpayer is conducting a hobby rather than a business, but that size is certainly not the determining factor.”

None the less, the taxpayer's evidence of his subjective purpose may establish profit purpose where an objective inference would not be drawn: Scott v. C. of T. (N.S.W.) (1935) 3 A.T.D. 142; Tweddle (1942) 7 A.T.D. 186. The relevance of subjective purpose will arise in a case where the taxpayer is seeking to establish that he is engaged in business so that he might be allowed a loss. The objective inference may be against a finding of profit purpose, because the operations conducted do not indicate any reasonable prospect that they will be commercially viable: there is no immediate or ultimate prospect of profit. It may be that the taxpayer's assertion that he had a profit purpose will be received with caution where the evidence is against any reasonable prospect of commercial viability. But if he is believed, the element of profit purpose is satisfied and in this respect the Australian law is different from New Zealand law. New Zealand courts have taken the view that whatever was the taxpayer's subjective purpose, there will not be a business unless there is a reasonable prospect of making a profit: Hanley v. C.I.R. (N.Z.) (1971) N.Z.L.R. 482; Prosser v. C.I.R. (N.Z.) (1973) 73 A.T.C. 6006. In Tweddle Williams J. in the Australian High Court rejected this view on the ground that it would require the Commissioner to be the judge of the viability of a commercial enterprise.

2.448 In the last paragraph the observations made relate to inferences to be drawn from, and subjective purpose of the taxpayer in regard to, the operations conducted by the taxpayer in the year of income. Where the objective inference is that there will be expanded operations which will be commercially viable, and the present operations are a step in the building up of a business, profit purpose will, it is submitted, be satisfied. The present operations should not be regarded in the way in which feasibility studies have been regarded. A feasibility study is not a business operation: it precedes the commencement of business. Where, however, an objective inference that operations will be expanded cannot be drawn—the land presently owned and devoted to the business by the taxpayer may be inadequate—a question arises whether the taxpayer's subjective purpose to expand the operations, if necessary by acquiring more land, will go to establish that there is a present business. Ferguson and Mullins would support a view that it is relevant, and that a subjective purpose to develop present operations into operations which will yield a profit is a sufficient profit purpose. The authority of Ferguson is confused by the conclusion that the taxpayer was engaged in a “preliminary” business, but it admits of explanation in the way suggested.

2.449 The idea of profit so far assumed is an excess of gains—which may be profits in the more specific sense of receipts exceeding costs of particular transactions—over the expenses of the operations in which those
gains are derived. It is an overall profit—the profit shown in a profit and loss account. A purpose to achieve such an overall profit is necessary. It is not necessary that each individual transaction should have been moved by a purpose to profit by that transaction. A purpose to profit in an individual transaction is essential only when it is sought to characterise that transaction as an isolated business venture. A so-called “loss-leader” transaction in a retailing business is a transaction of that business. The point was made by Barwick C.J. in Investment & Merchant Finance Co. Ltd (1971) 125 C.L.R. 249 at 255: “neither the attainment of profit nor the expectation of it is essential for a particular commercial transaction to form part of the business of dealing in the commodity purchased.”

2.450 There is, none the less, a question whether a particular transaction does form part of a continuing business. Barwick C.J. qualified his statement by referring to a “commercial” transaction. The suggestion intended may have been that any transaction which is “commercial” will be regarded as part of any business otherwise established. If so, the necessary relationship with undoubted business operations, must be too broadly stated whatever meaning was intended for the word “commercial”. The transaction must be incidental to the undoubted business transactions. The loss leader transaction is clearly incidental to a retail business. On the other hand, the transaction of acquiring and disposing of shares by a dividend stripper, as in Investment & Merchant Finance, is not incidental to the taxpayer's share trading business. Whether assessed objectively or subjectively, the taxpayer's purpose is not to further the gaining of profits in other transactions. The taxpayer's purpose is to obtain tax advantage, which would not have been thought prior to Investment & Merchant Finance, to be a profit in any sense relevant to the ordinary usage notion of income. (Cf. Loxton (1973) 47 A.L.J.R. 95.) If it be accepted that profit is not the purpose in the share stripping transaction, the transaction can only be part of the taxpayer's business of share dealing if it can be regarded as incidental to the business. It can only be incidental if the word is understood in a sense that would carry principle far beyond the loss-leader illustration.

2.451 Investment & Merchant Finance is one of the most unfortunate decisions in Australian tax law. It led to tax avoidance on a major scale. It had some support, at the time of the decision, in United Kingdom cases also concerned with dividend stripping: Griffiths v. J. P. Harrison (Watford) Ltd [1963] A.C. 1. Those decisions were thereafter reversed by the House of Lords: Thomson v. Gurneville Securities Ltd [1972] A.C. 661. The High Court was asked in Patcorp Investments Ltd (1976) 140 C.L.R. 247 to reverse Investment & Merchant Finance so as to hold that dividend
stripping transactions are not incidental to share trading. The High Court refused, asserting that correcting the law, if correction is necessary, was a matter for Parliament. Legislative endeavours to correct *Investment & Merchant Finance* have added their share of complexity to the Act, and such correction as has been achieved required several essays in amendment. *Investment & Merchant Finance* is one of a number of decisions of the High Court in recent years which have damaged basic principles. *Curran* (1974) 131 C.L.R. 409 and *South Australian Battery Makers Ltd* (1978) 140 C.L.R. 645 are others. Legislative correction has been attempted in many steps, and correction would seem never to be complete. The lesson may be that damage done by courts to basic principles must be repaired by courts: it is beyond repair by statutory provisions.

2.452 The notion of profit relevant to the characterising of operations as a continuing business is overall profit—an excess of gains over the expenses of the operations in which those gains are derived. The gains that are income from those operations will include gains to which those operations were immediately directed and gains which are incidental to those operations. Gains, for this purpose, will include exchange gains which arise in the receipt of payment of a debt on revenue account, or the discharge of a revenue liability. The gain, or loss which will be deductible, in this instance arises from a transaction which is incidental to transactions—the acquisition and sale of goods, or the provision of services—which are the core transactions of the business and moved by the profit purpose. *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347 is the leading case. Others are *Commercial & General Acceptance* (1977) 137 C.L.R. 373 and *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510. They are considered more closely in Chapters 6 and 12 below. Meanwhile, it may be noted that they vindicate the view taken in this Volume that the ordinary usage notion of income is concerned with gains. Where goods are sold there is a gain to the extent that the proceeds of sale receivable exceed the cost of those goods. Equally where payment is received there is a gain to the extent that the actual receipt exceeds the amount receivable at the time of the sale. In exchange gain situations the gain will have arisen because the proceeds of sale are receivable in a foreign currency, which has increased in value between the time of sale and the time of receipt of payment. The ordinary usage notion of income in this respect is displaced to a degree by the trading stock provisions of the Assessment Act examined in Chapter 14 but otherwise remains part of our law.

2.453 In the computing of business gains which are income, the notion of cost is historical cost. Developments in accounting practice which provide
alternatives to historical cost are not relevant to the ordinary usage notion of income gains. It will be seen in Chapter 15 that some correction of the ordinary usage notion was attempted during the period 1977–79 following recommendations made by the Mathews Committee (Report of the Committee of Enquiry into Inflation and Taxation, A.G.P.S., Canberra, 1975). But currently no correction is applied.

2.454 There is a question whether the gains which will be relevant in determining whether there is a profit purpose, so as to justify a conclusion that there is a continuing business, include gains which are income derived from property. A general conclusion that they do, would mean that the ordinary usage notion of income would extend far into the area of what have been regarded as capital gains. There are decisions which hold that investing to derive interest, dividends or rents, if done on a sufficient scale, constitutes a business. But the notion of business in these decisions is not necessarily the notion which is an aspect of the business gains principle in the ordinary usage meaning of income. If it were held that there is a business in the ordinary usage sense where the activity is the deriving of income from property and the profit purpose is simply to derive that income, it would be difficult to resist a conclusion that the acquisition and disposition of property whence the income is derived is a transaction incidental to the business, so that any gain from that transaction is income within the business gains principle. In fact no court has held, in the circumstances envisaged, that there is a business in the ordinary usage sense.

2.455 The so-called “banking” and “life insurance” company cases considered under the next heading might be thought to be contrary to the assertion just made. Putting aside collateral activities, a bank borrows money from customers to lend to others, or to invest in other ways—by acquiring rent producing property or shares. The core activity might therefore be said to be simply to derive income from property. Yet it is established that banking is a business, and that gains on realising of investments are income as being incidental to that business. A similar observation may be made in regard to the life-insurance cases. Clearly the possibility of there being what might be called a “business of investing” requires closer examination.

Business and investing

2.456 It may be accepted that there is no business, within the ordinary usage business gains principle, where an investment or any number of investments have been made with the purpose simply of obtaining income
derived from property—interest, rent, dividends—which attends the investment. To treat this income as supplying a profit purpose, so as to make the investing a business, would be to bring about a radical extension of the concept of income into the field of capital gains. A purpose simply to obtain income derived from property, it was submitted above, is not a profit purpose. In any case, on the hypothesis that the purpose is simply to obtain that income, there will not be any system in the taxpayer's activity such that a change in his investments can be seen as part of or as incidental to it. Sometimes the taxpayer will cease to hold the investment because he has been repaid money he has lent, or the company in which he invested has been liquidated. Sometimes he will have realised his investment because he has need, for some private purpose, of the money he had invested. None of these events is part of or incidental to whatever system there may be in obtaining the income derived from the investments.

2.457 A relatively small variation in the hypothesis about the taxpayer's purpose will require a re-examination of the conclusion that there is no business. Four variations have been considered in the authorities:

(1) the taxpayer's purpose includes a purpose to choose investments having regard to the prospect of increase in their value, and to realise investments so as to realise increases in value when they have occurred;
(2) the taxpayer's purpose includes a purpose to realise an investment if it appears that there is a risk that the investment will fall in value;
(3) the taxpayer's purpose includes a purpose to realise an investment if it should appear that increased flows of income from property can be obtained by an alternative investment of the proceeds of realisation. His purpose, it is said, includes a purpose of maximising income by “switching”; and
(4) the taxpayer's purpose includes a purpose to use funds he is obliged to return to others to meet calls for return which are a regular experience of his business, and to seek a profit by obtaining a greater amount, in the form of income from investments, than the cost of servicing the funds he is obliged to return. Realisation will be necessary from time to time to meet claims for the return of the funds.

2.458 Variation (1) has its parallel in the “classical” business of a merchant, save that the latter physically handles the stock in which he deals. It would be agreed that variation (1) is a business in which realisation is inherent.

2.459 Each transaction of acquisition and realisation would, very likely, if it stood alone, be a transaction within the first limb of s. 25A(1). The reservation in the words “very likely” is intended only to accommodate the interpretation of the first limb of s. 25A(1), which insists that the relevant purpose under that limb is subjective purpose. It is the number of transactions and an element of system that links them which must
distinguish a continuing business—a business of “dealing” in investments—from several s. 25A(1) transactions. The distinction is not always easily drawn. Yet there are important differences in consequences. A business of dealing in investments attracts the trading stock provisions. Section 25A(1) transactions do not. A loss on an individual realisation is deductible if there is a business of dealing. If the transaction is a s. 25A(1) transaction the availability of a loss is qualified by s. 52.

2.460 The element of system might be supplied by constant monitoring of the performance of all the investments traded, or by a practice of operating within the limits of funds regarded as available for trading, or by a combination of these and perhaps other practices. In theory, at least, a taxpayer may have one “portfolio” of investments in which he trades, another portfolio made up of investments to which s. 25A(1) applies, and yet another portfolio of “pure” investments.

2.461 A business of dealing would appear to be the explanation of the conclusion reached by Jacobs J. in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106 that the investment company had derived income in the form of gains on realisation of its investments. The company's policy was to realise an investment in shares whenever the dividend yield (the dividend as a percentage of the market value of the shares) on the shares fell below 4 per cent. In the stock market conditions which prevailed in the early part of the 1970s—a period of rising share values—this policy in fact involved the sale of shares that had increased in value. An increase in value, which might reflect an anticipation of a higher dividend on the next occasion of a dividend declaration, will cause a decrease in dividend yield, the dividend yield being calculated on the last dividend declared. Some passages in the judgment of Jacobs J. might suggest that he regarded the share transactions as a collection of s. 26(a) (now s. 25A(1)) second limb transactions, but this suggestion would appear to be contradicted by his acceptance of the principle of *Curran* (1974) 131 C.L.R. 409 in calculating the gains made by the taxpayer. *Curran* is the subject of comment in a number of contexts in this Volume including [12.85] below. For present purposes, it is enough to say that the case concerned a share trader.

2.462 There may be thought to be some difficulty, irrespective of whether *London Australia* is taken as a share trading or as a s. 26(a) case, in treating a policy going to the realisation of investments, as distinct from acquisition and realisation, as a policy which will make gains on realisation income. The difficulty in relation to a conclusion of share trading was expressed by Barwick C.J. (who dissented) in this way (at 113): “Those realisations could be said, in my opinion, to be a result of the nature of the company's business, but not part of that nature.” The answer may be that the policy of
the taxpayer involved both acquisition and realisation. The policy to sell shares whose dividend yield had fallen, was also a policy to buy shares that, in the conditions of the market at the time, would suffer a fall in dividend yield, because of a rise in values. In this event a conclusion that there was a business of dealing would be the more clearly justified.

2.463 *London Australia* has been referred to as authority for the view that an overall purpose to profit is an essential element in the concept of business in the business gains principle. The examination of purpose in all judgments can only be explained in that way. The difference between Jacobs J. and Barwick C.J. is in the need for purpose at the time of acquisition, where the profit purpose asserted is a purpose to profit by realisation. The difference between these judges and Gibbs J. is that Gibbs J. thought that a purpose to maximise income from property by switching of investments was a sufficient profit purpose.

2.464 Variation (2) is not enough to convert “pure” investing into a business. *Charles* (1954) 90 C.L.R. 598 remains authority to this extent. In *London Australia* both Gibbs J. and Jacobs J. explained *Charles* on the ground that the evidence established that the policy was to sell only when a fall in value was anticipated. So explained, the case reinforces the obvious. An investor does not have to wait till his conviction that a share investment has gone bad is confirmed, before he sells. There is a distinction between selling to realise an increase in value that has occurred, and selling to realise an increase in value that has been sought. The explanation of *Charles* given by Jacobs J. may indicate that, as suggested above, he saw the policy of the company in *London Australia* as a policy to buy shares that would suffer a fall in dividend yield because of a rise in value.

2.465 Variation (3) raises the question of the correctness of the view of Gibbs J. in *London Australia* that the profit purpose that will convert pure investment into a business includes a purpose to maximise income derived from property. Maximising income flows will require a change from an investment whose flow of income is low in relation to its value, to another investment offering a higher flow. The greater flow sought by the switching is a profit which will supply the element of profit purpose, and give rise to a business within the business gains principle. The realisation of existing investments is incidental to the derivation of the greater income from property, and any gain made by that realisation, or loss suffered, is income or deductible.

2.466 The view taken by Gibbs J. enabled him to find for the Commissioner, the taxpayer having made gains on realisation, by an interpretation of the policy pursued by the investment company which is more readily accepted than the interpretation adopted by Jacobs J. The
latter involves some extended inference from the circumstances of a rising share market. Gibbs J. sought authority in the banking and life insurance cases considered below in relation to variation (4). Both Jacobs J. and Barwick C.J. thought those cases were to be explained on a different basis. One at least of the cases, *Australasian Catholic Assurance Co. Ltd* (1959) 100 C.L.R. 502, would not appear to admit of explanation on the basis of switching. The view of Gibbs J. may, none the less, be the preferable basis.

**2.467** Variation (4) is an attempt to specify the circumstances which have been thought, at least by Barwick C.J. and Jacobs J., to explain the banking and life insurance cases. A bank, collateral activities aside, depends for its profit on a greater income flow from its investments than the cost of servicing borrowed money it has invested. It is implicit in its operations that it must be ready to effect some change in its investments to meet a call for a return of their money by those who have lent to it. Generally, the call can be met by some tightening of overdraft accommodation, and the consequent repayment by a customer of a loan will not generate a gain unless the loan has been made in a foreign currency and there is an exchange gain. But the failure to obtain repayment will generate a loss on the lending transaction which the bank will wish to deduct. Deductibility is a corollary of a conclusion that there would have been income had there been a gain. The deduction of a loss under s. 51 is thus linked with the existence of a business within the ordinary usage business gains principle. The Barwick C.J. and Jacobs J. explanation of the banking cases is that the obtaining repayment of a loan made by a bank, or the realisation of an investment it has made, is incidental to the making of a profit by a margin of income flows over the costs of servicing. A similar analysis may be made in relation to a life insurance business. The principal banking and life insurance cases are referred to in the judgments in *London Australia*. They are *Punjab Co-operative Bank Ltd v. Income Tax Commissioner, Lahore* [1940] A.C. 1055, *Commercial Banking Co. of Sydney Ltd* (1927) 27 S.R. (N.S.W.) 231, *Colonial Mutual Life Assurance Society Ltd* (1946) 73 C.L.R. 604, *Australasian Catholic Assurance Co. Ltd* (1959) 100 C.L.R. 502.

**2.468** So explained, the investments, changes in which will be acts in carrying on the business, will be those made in contemplation of the need to change in order to meet calls by customers for the return of their deposits, or by policy holders for the proceeds of their policies. An investment in shares so as to control a company will not ordinarily be such an investment: *The National Bank of Australia Ltd* (1969) 118 C.L.R. 529.

**2.469** Assuming that the banking and life insurance cases are to be explained in this way, there is a question of how far the principle that they
express extends. It would be assumed that the prospect that an investment company may have to realise investments, in order to finance a dividend paid to shareholders, is not enough to attract the principle. It may be asked whether the situation of the trustees of a unit trust, or the situation of a mutual fund which is an unlimited liability company, is different. In each case, there may be a need to realise investments to buy out a unit holder or a shareholder, under provisions which give the unit holder or shareholder a right to redeem.

2.470 Where an investment company uses borrowed funds in making investments, the banking cases may require a conclusion that gains on changes in investments are income. If it is agreed that, generally, the explanation of the banking cases would have no application to a company using its shareholders' funds in investment, there will be problems of severing this investment activity from other investment activity by the same company using borrowed funds. Tracing of funds, so as to distinguish business investment from pure investment, would be impossible, and any apportionment of profits from realisation so as to distinguish income from non-income elements, may be precluded by the decisions in *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341, considered in relation to Proposition 15. The banking cases do not, however, dictate a conclusion that gains on the realisation of investments by an investment company in order to repay a borrowing, are income. The repayment of borrowings is not a regular experience of the business in the way in which meeting the calls of depositors is a regular experience of banking business.

2.471 If the banking and life insurance company cases have no application to a company using its shareholders' funds in investment, there may be room for banks and life companies to avoid the operation of those cases by a reorganisation which will pass the investment activity to a wholly owned subsidiary, which will realise investments when asked by the parent, and will make funds available to the parent, perhaps by way of loan. It should not, however, be beyond judicial decision to attribute to the subsidiary the purpose in realisation that would be the purpose of the holding company.

2.472 If a company lending its own funds is not in a business, so as to attract the business gains principle, it will follow, a fortiori, that an individual money lender using his own funds is not in business. At least this is so if the banking and life insurance cases need to be relied on. It is possible that money lending in some circumstances involves system and profit purpose sufficient to make the lending a business. The money lender will generally wish to claim that there is a business so as to attract a loss deduction, if he is not repaid the money he has lent. It should be noted that s. 63 is a specific provision which may allow him a loss. The word
“business” in that section will attract the definition in s. 6, and possibly does not have the meaning it has in the ordinary usage gains from business principle.

2.473 A conclusion that a money lender is in business, because turning over of his lendings involves system directed to achieving the maximum return from his lendings, would follow from the view of Gibbs J. in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106. Switching directed to maximum return from investment is a business activity that may yield profits that are income or losses that are deductible. And that view offers an alternative explanation of the banking and life insurance cases, an explanation preferred by Gibbs J. The explanation has its parallel in the explanation of the income character and the deductibility of exchange gains and losses offered in the discussion in [6.329] and [12.192] below of AVCO Financial Services Ltd (1982) 150 C.L.R. 510 and Hunter Douglas Ltd (1983) 83 A.T.C. 4562. The function of the borrowings in AVCO was their use in a business of lending. It is suggested in the discussion that it was not this that gave a revenue character to the liabilities to repay. It was the fact that the company engaged in a repetitive activity of borrowing directed to minimising its costs of borrowing. If AVCO is to be explained in terms of the function of the borrowing, Hunter Douglas may be thought to be wrongly decided. But there is enough in the judgments in AVCO and in Hunter Douglas to explain those decisions on the ground that the borrowings were a number of repeated and systematic borrowings directed to minimising the costs of borrowing.

2.474 The Federal Court decision in The Chamber of Manufacturers Insurance Ltd (1984) 84 A.T.C. 4315 has extended the principle of the banking and life insurance cases to other insurances. The court quoted from Colonial Mutual Life Assurance Society Ltd (1946) 73 C.L.R. 604 at 618 in support of this extension, though the support given by the quotation is little more than what might be drawn from the absence of the word “life” before “insurance” in referring to the principle. There are, however, United Kingdom decisions, including General Reinsurance Co. Ltd v. Tomlinson [1970] 1 W.L.R. 566, which would support the extension. In Chamber of Manufacturers the insurance business was primarily in the field of workers' compensation. The case concentrates on a concept of a “reserve fund” of investments which will be treated as revenue assets. Banking and life companies must hold assets to meet inevitable calls by depositors and policy-holders. In both instances they are calls, in effect, for return of moneys vested in the company by the depositors or policy-holders, more obviously so, perhaps, in the case of a bank than in the case of a life company. The extension of the principle to other insurance companies
modifies the principle, so that it now extends to assets held to meet contingencies whose occurrence may be statistically predictable but which are not inevitable in the way the claim of a depositor in a bank or policy-holder in a life company is inevitable. The extension paves the way for yet another modification which would treat assets as revenue assets whenever a business need to realise them may be fairly anticipated. As so modified the principle would extend to assets that represent a temporary investment during a period of excess liquidity of a business, due, for example, to seasonal factors. And it might extend to any assets of a taxpayer carrying on a business: they stand available to meet claims made against the company, whether by creditors or others. The reasoning in Chamber of Manufacturers suggests that in the illustration of excess liquidity, the assets are a reserve fund. The court considered that for various reasons, including the possibility of legislative exclusion from the industry, the company might have to realise some of its investments, presumably so as to diversify into some other business activity to replace the lost insurance activity. In this there is an assumption that investments of money which may need to be redeployed in the business activities of a taxpayer are revenue assets. The assumption challenges the very existence of a distinction between revenue assets and capital assets. The illustration of assets treated as revenue assets because they stand available to meet claims made against the company by any creditor will abandon the distinction.

2.475 The notion of “reserve fund”, as it is used in Chamber of Manufacturers, is ill-defined. It must refer to assets representing a reserve to meet claims. Not all assets of an insurance company will be treated as a “reserve fund”. Assets, referred to in the case as hard-core funds, that will be called on to meet current expenses are assumed by the Federal Court to be revenue assets, however they are designated. The test here is presumably the manner in which the assets are called on to meet expenses. They are called on as a matter of the regular experience of the business. What assets are a reserve fund in this way is a matter of objective inference, though the proclaimed intention of the taxpayer in regard to the assets may assist the characterisation. Where the asset is money held in a trading account with a bank a conclusion that the asset is a revenue asset is most likely to be drawn. The character of such an asset as a revenue asset is the subject of some discussion in [6.52]–[6.77] below where the question is the deductibility of a loss incurred on the deprivation of the asset.

2.476 In regard to other assets, reserve fund character according to Chamber of Manufacturers is at least prima facie a matter of designation by the taxpayer, though the nature of an asset may be the basis of an objective characterisation. Thus the investment in shares in National Bank
referred to in [2.468] above would not generally be part of the reserve fund. Nor would the investment in the head office building of an insurance company be part of its reserve fund. In *Chamber of Manufacturers* it was argued that investment in shares carried a designation of the shares as not being part of the reserve fund, when there were other investments that were fixed return investments, more especially if the fixed return investments were in fact called on to meet claims. The Federal Court did not accept the argument. Some express designation by classification in the books of account may be necessary to ensure that assets are outside the reserve fund. The designation will not, it seems, be definitive unless the assets designated as reserve are “demonstrably sufficient to meet claims and expenses in all reasonably foreseeable contingencies” (1984) 84 A.T.C. 4315 at 4318-9. The notion of “sufficient to meet claims and expenses in all reasonably foreseeable contingencies” is broad indeed and suggests the possibility referred to in [2.473] above of a reserve fund characterisation of all assets applicable to all taxpayers engaged in business.

2.477 The words quoted from *Chamber of Manufacturers* suggest that a designation of assets as pure investments, and thus not part of the reserve fund, will not be accepted where the assets designated as reserve fund are not “demonstrably sufficient to meet claims and expenses in all reasonably foreseeable contingencies”. There is some parallel with the view expressed in *Lomax v. Peter Dixon & Son* [1943] K.B. 671 that a premium will not be treated as a receipt for the capital risk in lending, and thus not income, unless a commercial rate of interest is payable on the money lent. If the designation as pure investments is not accepted, there will be a question whether the whole of the assets designated as pure investments must be treated as reserve fund. *Chamber of Manufacturers* may suggest that they must be. Which raises a question of the validity of a principle that would take an asset out of reserve fund status if its inherent character, as in the case of the shares in *The National Bank of Australia Ltd* (1969) 118 C.L.R. 529, or the head office building in the illustration given in *Chamber of Manufacturers*, makes it a pure investment. At this point, if not earlier in this discussion, there appears reason to doubt the extension of the banking and life insurance cases attempted in *Chamber of Manufacturers*.

**Revenue assets and structural assets**

2.478 In the foregoing discussion a concept has emerged of an asset whose realisation is inherent in, or incidental to, the carrying on of a business. The phrase adopted to identify such an asset is “revenue asset”. It is to be distinguished from a “structural asset”, which forms part of the “profit
yielding subject” of the business. The words “structural” and “profit-yielding subject” have become accepted in our law through a number of judgments of Dixon C.J. which are referred to in Chapter 7 below. The phrase “revenue asset” is a coinage of this Volume. The case law has adopted a phrase “liability on revenue account” or “revenue liability” for purposes of explaining the law in regard to exchange gains and losses. It is a short step to the use of the phrases “asset on revenue account”, or “revenue asset”.

2.479 The phrase revenue asset is helpful as identifying all assets of a business that are not structural. Revenue assets will include stock-in-trade but that phrase is too specific in its meaning to be useful in identifying all nonstructural assets of a business.

2.480 In the discussion of Proposition 13, the possibility that a contract to provide services is a revenue asset of a business of providing services was explored. A contract under which an accountant is entitled to do accounting and audit work for his client may be a revenue asset: Ellis v. Lucas [1966] 3 W.L.R. 382, cf. Walker v. Carnaby Harrower, Barham & Pykett [1970] 1 W.L.R. 276.

2.481 An amount received for the surrender of rights under such a contract by the proprietor of the business, so far as it exceeds any costs which were not deductible, will be an income receipt as a gain which arises from an act in carrying on the business. The reference to costs which were not deductible is intended to preserve the principle expressed in Proposition 4. Most often there will not be any such costs. The costs of obtaining the contract will have been immediately deductible and not required to be treated as costs that must be deferred until the asset is realised. But in some circumstances the cost must be deferred, and will be subtractable not under the general deduction section—s. 51—but as a cost which enters the determination of the amount of any receipt on realisation which is a gain as a profit on realisation. Thus an amount paid for the assignment of an agency, or for the grant of a sub-agency, is a cost which should be deferred. It will be subtracted in determining how much of an amount received for a surrender of rights under the agency or sub-agency is income.

2.482 These matters are more closely explored in Chapters 5 and 12 below. It is enough for present purposes to say that not every expenditure is pure expense, or in the language of s. 51, an outgoing. Nor is every receipt pure gain. An expenditure which is immediately represented by an asset acquired by that expenditure, is not an outgoing, at least when the asset is not a wasting asset—an asset that may be said to be consumed in the process of deriving income. It will, however, be a cost that must be
allowed in determining how much of a receipt on realisation of the asset is a gain and thus income, or a loss and deductible under s. 51(1). Where an expenditure less directly contributes to the acquisition of an asset, it is more appropriate to treat it as a pure expense deductible under s. 51. Legal costs associated with obtaining a contract to provide services which is a revenue asset may be treated in this way, and the proceeds of surrender of rights under the contract will be gain as to the whole of the amount.

2.483 Section 82 of the Assessment Act will preclude any cost allowed as a deduction being treated as a cost in determining the gain from the surrender of rights. Where expenditure is immediately represented in trading stock as defined in the Assessment Act, ss 28ff. and s. 51(2) displace the principle that the expenditure is not an outgoing. It is immediately deductible but, it will be seen, a countervailing item brought in as income has the effect of requiring a deferral of the outgoing, if the stock is not realised until a subsequent year. In effect the deduction of the outgoing and the bringing in of the proceeds of realisation are made to occur in the same year of income.

2.484 The range of assets that may be revenue assets of a business is without limit. Attention has been given in [2.456]–[2.477] above in relation to the present proposition, to the circumstances in which investments will be revenue assets of a business. The circumstances in which an agency contract may be a revenue asset were considered, in relation to Proposition 13, in [2.384]–[2.407] above, and there was some discussion of the question whether one's freedom of action may be seen as an asset whose realisation can give rise to income.

2.485 There may be a contract under which the taxpayer is entitled to distribute the goods of a particular manufacturer. The typical case is I.R.C. v. Fleming & Co. (Machinery) (1951) 33 T.C. 57 involving an agency to distribute in Scotland explosives manufactured by Imperial Chemical Industries. The contract will be a revenue asset, unless it represents a very substantial part of the taxpayer's business. The cases have tended to make some kind of mathematical assessment of significance, in terms of the proportion that business under the contract is of the taxpayer's total business activity, the period of the contract still to run, how far it is terminable, and the prospect of renewal. A question of what is the relevant business activity for this purpose is raised. The cases, principally Fleming, Wiseburgh v. Domville [1956] 1 W.L.R. 312 and Sabine v. Lookers (1958) 38 T.C. 120, do not decide whether it is all the business activity carried on by the taxpayer, or business activity involving agencies of a kind similar to that with which the case is concerned. The test of the significance of the contract adopted in Fleming is whether its loss will “cripple” the taxpayer's
business. The giving up of an agency must necessarily involve the loss to the taxpayer of the goodwill he has built up as a seller of the goods of his manufacturer. No special attention has been given in the cases to the significance of this loss of goodwill. Yet, it seems, a restrictive covenant that the taxpayer may undertake as an aspect of the agreement by which he ceases to be agent is of special significance. What he receives under the agreement for giving up his capacity to deal in goods of the kind supplied by his manufacturer is unlikely to be an income receipt. His capacity will be seen as a structural, not a revenue asset. Fleming would suggest that this is so even though his manufacturer has a virtual monopoly in the manufacture of the goods in question, and the loss of the agency will itself involve a loss of what capacity he had to deal in goods of the kind supplied by the manufacturer. In this regard a rule of extended form seems to be applied to an agreement to give up capacity.

2.486 The agency agreement may be one by which the taxpayer has an outlet for his services in the selling of another's goods, in advertising another's goods or in the management of the business of another. The United Kingdom cases, in particular Barr, Crombie & Co. v. I.R.C. (1945) 26 T.C. 406—a case involving a contract to manage the shipping business of another—suggest that the principles applicable are the same as those applicable where the contract is one by which the taxpayer obtains the supply of goods to sell. It is a matter of the significance of the contract as an asset of the taxpayer's business. The Australian authority, Heavy Minerals Pty Ltd (1966) 115 C.L.R. 512, referred to in the next paragraph, may however suggest that an agency contract by which a taxpayer has an outlet for the services he supplies attracts different principles, and will always be a revenue asset. An import or export entitlement may be thought to be analogous to rights under an agency agreement. In Merv Brown Pty Ltd (1984) 84 A.T.C. 4394 importing under import entitlement at a concession rate of customs duty made up some 40 per cent of the taxpayer's business. The conclusion reached that the import entitlements were structural assets does not sit easily with the agency cases, more especially since several distinct entitlements were judged together in determining their significance. And the relevance of the observation by Kaye J. that sales of import entitlements were not “normal incidents” (at 4406) of the taxpayer's trading activities, is not apparent. That observation could as well have been made of the giving up of the agency agreement in Fleming or Wiseburgh.

2.487 It is apparent from the agency cases just considered that a receipt for giving up one's freedom of action is unlikely to be held income, though Higgs v. Olivier [1952] Ch. 311 would indicate that a partial giving up of
freedom of action may in some circumstances be an income receipt. Freedom of action may be a revenue asset if the partial giving up can be regarded “as in the ordinary run of the profession or vocation” of the taxpayer: Evershed M.R. at 315. There is a like suggestion in the judgment of Dixon C.J. in *Dickenson* (1958) 98 C.L.R. 460, a case considered in [2.411]–[2.415] above. Characterisation of a submission, by an agreement, to a restriction on freedom of action will not necessarily be determined by the form of the agreement. A receipt for a restrictive covenant not to remain in or enter a particular market should not be treated as a receipt for giving up freedom of action if in fact the taxpayer has no business in that market, and no prospect of such business. If the agreement in *Rolls-Royce v. Jeffrey* (1962) 1 W.L.R. 425 by which Rolls-Royce supplied aircraft engines to particular buyers in various markets had included restrictive covenants against supply to others in those markets, characterisation of receipts for those restrictive covenants as receipts for the giving up of freedom of action would rightly have been rejected. The evidence established that there were no other potential buyers in those markets.

2.488 A contract under which a merchant is entitled to the supply of goods may be a revenue asset. The agency cases will afford what principles there may be to determine the character of the contract. A contract under which a taxpayer is entitled to supply goods to another may be a revenue asset: *Heavy Minerals* suggests there is a distinction between a contract under which stock is obtained, and a contract which merely assures an outlet. The former may be structural. The latter, the case suggests, will always be revenue. But where the person with whom the taxpayer has a contract to supply is one of a very few possible customers for the taxpayer's goods, there may be reason to regard the contract as structural. A long term supply agreement between an Australian mining company and a Japanese importer might be regarded differently from the agreement in *Heavy Minerals*. It may be asked whether it is appropriate to distinguish the export entitlements of a meat exporter from the import quotas of a merchant, where the entitlements and quotas are of equal importance to the taxpayer concerned.

2.489 The leading case in which a contract was held to be a structural asset is *Van den Berghs v. Clark* [1935] A.C. 431. The contract implemented a cartel arrangement between the taxpayer, a manufacturer of margarine, and a Dutch company, also a manufacturer of margarine. Two quotations may indicate the reasons for the conclusion that the contract was structural (at 442–443):

“The three agreements which the appellants consented to cancel were not ordinary
The impression that remains is that the characterisation, as revenue or structural, where the asset is a contract, is a matter of degree of importance of the contract to the operations of the business. Being a matter of degree, the conclusion in a marginal situation must always be perplexing, however reinforced it may be by repetition and forceful statement.

2.490 One explanation of Rolls-Royce v. Jeffrey [1962] 1 W.L.R. 425 is that the company had made the selling of its know-how an activity of its business. What would otherwise have been a structural asset had, in the circumstances, become a revenue asset. The suggestion is that any characterisation of an asset is not final. It must be made in the context of the particular act of realisation. Rolls-Royce, it must be admitted, is capable of other explanations. One of these would assume that the know-how of the taxpayer remained a structural asset and the transactions under which the know-how was sold were equivalent to non-exclusive licences to use the asset. The receipts were thus income derived from property. This would appear to be the explanation of the case in others that have followed it: Musker v. English Electric Co. Ltd (1964) 41 T.C. 556, Coalite & Chemical Products Ltd v. Treeby (1971) 48 T.C. 171, John & E. Sturge Ltd v. Hessel (1975) 51 T.C. 183, Thomson’s (Carron) Ltd v. I.R.C. (1976) 51 T.C. 506. Yet another explanation is offered in dealing with Proposition 13. There was no asset sold or made available to the buyer. The company simply performed a service for the buyer— instructing the buyer in methods of manufacture—and the receipts were income as rewards for services.

2.491 None the less, the notion of a structural asset becoming a revenue asset in the circumstances of realisation cannot be dismissed, though the tax accounting problems that will arise are formidable. A distributor of motor vehicles may use a new motor vehicle as a “demonstrator”.

commercial contracts made in the course of carrying on their trade; they were not contracts for the disposal of their products, or for the engagement of agents or other employees necessary for the conduct of their business; nor were they merely agreements as to how their trading profits when earned should be distributed as between the contracting parties. On the contrary the cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants' activities, defined what they might and what they might not do, and affected the whole conduct of their business. I have difficulty in seeing how money laid out to secure, or money received for the cancellation of, so fundamental an organisation of a trader's activities can be regarded as an income disbursement or an income receipt. . . . The agreements formed the fixed framework within which their circulating capital operated; they were not incidental to the working of their profit-making machine but were essential parts of the mechanism itself. They provided the means of making profits, but they themselves did not yield profits. The profits of the appellants arose from manufacturing and dealing in margarine.”
Thereafter he may sell the vehicle as an item of his stock of new and used vehicles. A view that the item is at all times a structural asset will leave the depreciation provisions of the Assessment Act to operate alone. Some complications will arise if the vehicle is treated as having been at all times a revenue asset. It is arguable that the acquisition and sale of a demonstrator is incidental to the carrying on of a business of selling new motor vehicles just as a demonstration home may be a revenue asset of a project builder. The complications will involve the interrelations of the depreciation provisions—which can, it seems, operate where the cost of plant is revenue expenditure—the ordinary usage business gains principle and the trading stock provisions. There will be even greater complications if the analysis adopted is that the item is a structural asset while it is used as a demonstrator, and becomes a revenue asset and trading stock at the time it becomes available for sale. There will need to be a valuation at this time to determine the cost of the item for purposes of the trading stock provisions. It would make for a sensible interrelationship between the depreciation provisions and the trading stock provisions, if the fact that the item becomes available for sale were treated as a disposition of the item so that a balancing charge, or an allowable deduction, might then arise under s. 59. But the notions of disposition in s. 59 may not be flexible enough. These matters are raised again in [12.99]ff. and [14.38] below.

Isolated business venture

2.492 In [2.431] above, a distinction was drawn between a continuing business and an isolated business venture. That distinction and its significance call for closer examination. And it is necessary to examine the correlation between the law in regard to an isolated business venture and the specific provisions of s. 25A (formerly s. 26(a)). The latter provisions are the subject of detailed study in Chapter 3 below.

2.493 *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 is a landmark decision in its holding that there is a part of the ordinary usage meaning of income that is concerned with the notion of profit from an isolated business venture, and this is an element of the meaning of income for purposes of the Assessment Act. It is such an element as part of the ordinary usage meaning of income, and not by reason of the specific provisions of s. 25A (1), which may in their terms appear to cover some of the same field. Gibbs C.J. and Mason J. decided *Whitfords Beach* by the application of the isolated business venture notion and not by the application of s. 26(a). Wilson J. was content to rely on the second limb of s. 26(a) without rejecting the possible operation of the ordinary usage notion. Wilson J. did
not have to consider the consequences of a conflict between the ordinary usage notion and s. 26(a), because none arose in relation to the facts of the case. For the same reason Gibbs C.J. and Mason J. did not need to consider possible conflict. They were, however, conscious of the possibility of conflict in other circumstances, and they sought to lay the basis in doctrine for avoiding conflict by asserting that s. 26(a) had no application where the notion of isolated business venture will bring in a profit as income for purposes of the Assessment Act. Gibbs C.J. said (at 366–367):

“However, the fact that the profits yielded by some transactions which fall within the literal meaning of the words of s. 26(a) will not be brought to tax under that provision, since the transactions form part of a more extensive business, supports the view that s. 26(a) does not apply where s. 25(1) is applicable. Moreover, any business conducted for profit can be described as a profit-making undertaking or scheme, but it is impossible to suppose that the Parliament intended (contrary to settled practice) that the profits of every business should be dealt with under s. 26(a) rather than under the general provisions of s. 25. Not without some doubt I have therefore reached the conclusion that although the provisions of s. 26(a), if given full effect, would overlap those of s. 25, the second limb of s. 26(a) applies only to ‘profits not attributable to gross income that has already been captured by s. 25’, to use the words of Mason J. in . . . Bidencope (1978) 140 C.L.R. at 555.

It is implicit in what I have said that I consider that the second limb of s. 26(a) includes profits which would not otherwise have fallen within s. 25, because they could not be described as income in the ordinary sense. I have discussed that question in . . . Bidencope (1978) 140 C.L.R. at 551–552, and adhere to what I there said in relation to this aspect of the matter.”

Mason J. said (at 382–383):

“One view is that s. 26(a) should be applied to the cases which fall within its terms, to the exclusion of s. 25(1)—see Reseck . . . (1975) 133 C.L.R. 45 at 49, 57. After all, s. 26(a) is a specific provision introduced for the purpose of catching profits yielded by the transactions which it describes. Moreover, it has generally been applied to cases falling within its terms without the court examining in detail whether s. 25(1) might also have had an application (Steinberg (1975) 134 C.L.R. at 710; Bidencope (1978) 140 C.L.R. at 552; . . . St Hubert's Island Pty Ltd (In liq.) (1978) 138 C.L.R. 210, at 229–230; Pascoe . . . (1956) 30 A.L.J. 402).

The second view is that s. 26(a) will only operate when s. 25(1) does not do so (Investment and Merchant Finance (1971) 125 C.L.R. at 255, 264; Steinberg (1975) 134 C.L.R. at 688). This is the view which I have been disposed to favour in the past (see St Hubert's Island (1978) 138 C.L.R. at 229–230; Bidencope (1940) 140 C.L.R. at 555). Its rationale is that s. 26(a) should be considered as supplementary to s. 25 (1) which continues to operate as the principal statutory provision on the revenue side. As I have already indicated, it was no part of the purpose of s. 26(a) to limit the operation of s. 25(1). Indeed, in large measure its object was to ensure that the Revenue did not suffer in the event that s. 25(1) received a more restricted...
application than it was then thought to have. I am still inclined to think that this is the preferable view and that, accordingly, the second limb of s. 26(a) applies only to ‘profits not attributable to gross income that has already been captured by s. 25’ (Bidencope (1978) 140 C.L.R. at 555).”

2.494 It may be expected that the law that governs the notion of an isolated business venture will be drawn from principles that may be expressed in United Kingdom case law that has grown around the reference in the United Kingdom Income & Corporation Taxes Act 1970, s. 526 (and its previous equivalents), to an “adventure in the nature of trade”. The submissions by the Solicitor-General to the Privy Council in McClelland (1970) 120 C.L.R. 487 made the assumption that this case law did express principles which were part of the Australian law.

Gain or loss from an adventure in the nature of trade

2.495 Any attempt to state the United Kingdom law on the meaning of trade in the context of an isolated venture is fraught with difficulties. Authorities seem to go in pairs, the one appearing to stand for some proposition, the other contradicting that proposition. The explanation of the seeming contradictions, we are told, is that the United Kingdom regards the existence of a trade in a particular case as a question of fact, and it follows from the United Kingdom system of appeals that a court, which must find an error of law, cannot upset the finding by the Commissioners, save where the only reasonable conclusion on the basis of the state case contradicts the conclusion of the Commissioners. Presumably, trade is a concept of law, but one so lacking in definition that there is a broad marginal area within which the decision of the Commissioners must stand. Another difficulty is that the United Kingdom authorities, while recognising the distinction between continuing business activities and an isolated venture, have not sought to formulate that distinction. In what follows, principles have simply been drawn from cases where there is no indication that there was any element of repetition, at any rate repetition of the acquisition of property of the kind which was realised in the venture. And the assumption has been made that these cases are those which explain the scope of what is identified by the phrase “adventure in the nature of trade”.

2.496 Whether or not there is an adventure in the nature of trade is, it seems, a matter of objective inference. None the less, it is said that the subjective purpose of the taxpayer is important, though not conclusive. The reconciliation of these two propositions is not easy. The first is associated with statements that a purpose to profit is not an essential quality of trade. These statements have parallels in our continuing business law. But both in
the United Kingdom and in the Australian law they need to be received with some caution. An overall purpose to profit, objectively inferred, is a necessary quality of trade, though it is not enough to require a conclusion that there is a trade. Where an objective inference of purpose to profit cannot be drawn, a subjective purpose to profit may make an isolated venture a trade. But a subjective purpose is neither necessary (I.R.C. v. Incorporated Council of Law Reporting (1888) 22 Q.B.D. 279), nor sufficient (Jones v. Leeming [1930] A.C. 415).

2.497 The transaction must “exhibit features which give it the character of a business deal”. The phrase is taken from the Privy Council’s judgment in McClelland (1970) 120 C.L.R. 487 at 495. In the context it is evident that the Privy Council saw it as a requirement of adventure in the nature of trade. Another phrase used by the Privy Council which, presumably, is synonymous, is a “trade of dealing . . . albeit on one occasion only” (at 496). Neither phrase is exactly definitive. Some of the United Kingdom cases which bear on the meaning of these phrases are concerned with the principle already stated that there will not be a “business” or “trade” unless an objective inference of profit-making is to be drawn. (Cooke v. Haddock (1960) 39 T.C. 64, Johnston v. Heath (1970) 1 W.L.R. 1567.) These cases draw a distinction between “business” and “investment”, a distinction which does not always sit well with the aspect of the Australian notion of continuing business seen in the judgment of Gibbs J. in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106. But it is clearly a relevant distinction in the context of an isolated venture. In the same cases and others a distinction is drawn between holding for “business” and holding for “enjoyment” or “pride of possession”. The latter may cover the holding of broad acres which are not let to another or put to any productive use.

2.498 But the features which are necessary to give a transaction the character of a business deal or of a trade of dealing on a single occasion, include an elusive factor that is more than purpose to profit. This elusive factor may not be capable of any more precise defining than to say that the transaction must be the sort of thing a business man or man in trade does. In this context “business man” or “man in trade” brings in received ideas in the community about how such people behave.

2.499 A taxpayer may acquire and sell land and not engage in trade, provided there is a decent interval between acquisition and disposition so that he does not appear too concerned about his profit, or, if circumstances have required him to sell soon after acquisition, he did not contemplate quick sale when he acquired (Turner v. Last (1965) 42 T.C. 517, Eames v. Stepnell Properties Ltd [1967] 1 W.L.R. 593). A taxpayer may acquire shares and not engage in trade. Indeed as a director of a company he may
be required to own some shares. A taxpayer may sell shares and not engage in trade, provided he is not too hasty about it. But a taxpayer does engage in trade if he buys “a large quantity of a commodity like whisky, greatly in excess of what could be used by himself, his family and friends, a commodity which yields no pride of possession, which cannot be turned to account except by a process or realisation”. The words quoted are from the judgment of Lord Normand, in *I.R.C. v. Fraser* (1942) 24 T.C. 498 at 502–503. Lord Normand added that he could not consider a person who did this as “other than an adventurer in a transaction in the nature of a trade”. A taxpayer does engage in trade if he buys one million rolls of toilet paper (*Rutledge v. I.R.C.* (1929) 14 T.C. 490), or if he buys the Government's surplus stock of aeroplane linen and embarks on its sale to more than one thousand purchasers: *Martin v. Lowry* [1927] A.C. 312. A taxpayer may engage in trade if he sets up an elaborate selling organisation to effect the sales. He may engage in trade if he carries out some manufacturing process and sells the manufactured goods (*I.R.C. v. Livingston* (1926) 11 T.C. 538 at 543–544, per Lord Sands).

2.500 The cases may suggest that it is less likely that a conclusion that there is a trade will be reached if the transaction is in shares or land rather than in some other kind of property. Shares and land are traditional subjects of investment activity—activity that is not directed to profit-making in the turning over of the property acquired. An isolated transaction in land or shares does not necessarily yield an objective inference of profit purpose, when the same transaction in another kind of property may yield such an inference. A subjective purpose of profit-making, of which there may be evidence, will not in itself give the character of trade: *Jones v. Leeming* [1930] A.C. 415.

2.501 A taxpayer may not engage in trade even though he spends money to enhance the value of land before selling it, and thus realises the land in an advantageous way (*Taylor v. Good* [1974] 1 W.L.R. 556; *Rand v. Alberni Land Co.* (1920) 7 T.C. 629). The money may have been spent in clearing, subdivision, forming roads and provision of essential services. But he may engage in trade if he acquires property to be dealt with in this way and then sells it (*Pilkington v. Randall* (1966) 42 T.C. 662). Where he has not acquired for the purpose of development and sale, but the development extends to building houses on the land, a taxpayer may engage in trade though there is no authority that directs such a conclusion. The basis of a distinction between circumstances which are a “mere” advantageous realisation and circumstances which are an advantageous realisation that amounts to a trade, is not evident in the cases. The very word “advantageous” in the description of the circumstances indicates that an
objective inference of profit purpose can be drawn. The word "advantageous" must go to purpose. It is not a matter simply of advantageous in fact. The description "mere" advantageous realisation may be concerned to express the lack of a sufficient demonstration of system and organisation in the circumstances to make them a trade. Where the question is whether there is a continuing business, repetition supplies an element which must be found in the case of an isolated business venture in the isolated venture itself. If a conclusion that there is a business does not admit of any definitive answer, a judgment must be made in terms of the facts and precedent, rather than principle.

2.502 The scope of the notion of advantageous realisation as an aspect of Australian isolated business venture law was the principal concern of the High Court's decision in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355. The absence of any precedent that will explain the conclusions of Gibbs C.J. and Mason J. that there was an isolated business venture is starkly evident in the way each judge made use of authority. Gibbs C.J. concluded there was an isolated business venture after rejecting *Official Receiver (Fox's case)* (1956) 96 C.L.R. 370 and accepting *Scottish Australian Mining Co. Ltd* (1950) 81 C.L.R. 188. Mason J. reached the same conclusion after accepting *Fox's case* and rejecting *Scottish Australian Mining*. Both considered that there was something specially significant in a circumstance in *Whitfords Beach* that was not present in *Scottish Australian Mining*: there had been a change in proprietorship of the taxpayer company closely associated with the change in the purpose for which the taxpayer held the property, a change from a purpose to provide access to other properties owned by its shareholders, to a purpose of development to provide a profit which would be available for distribution to its new shareholders. An assertion of the significance of a change of purpose of the company, reflecting a change to a new set of proprietors with a new purpose, introduces a new factor, which goes not to the characterisation of facts but to a widening of the facts that have to be characterised. In effect both judges treated the case as if there had been a new acquisition of the land by the company, this time for the purpose of development and sale, because the new proprietors of the company had acquired the shares in the company for the purpose of moving the company to undertake the development and sale of the land. The decision thus involves a "piercing of the corporate veil" so as to find an acquisition by the company for the purpose of development and sale in the acquisition of shares by the new proprietors. In the result the case does not assist in determining the degree of system and organisation that will take circumstances out of the mere advantageous realisation notion, beyond a
confirmation that acquisition for development and sale may be seen differently from development and sale of property that had been acquired for some other purpose. If there had been no change in shareholding in Whitfords Beach, and the old shareholders had moved the company to undertake the development, the circumstances would presumably have been held by all judges to be a mere advantageous realisation.

2.503 The difference between the views expressed by Gibbs C.J. and the views expressed by Mason J. on the precedents of Fox's case and Scottish Australian Mining leaves the law even less determinate than ever, where piercing the corporate veil is not appropriate or necessary. If the view of Mason J. had been the view of both judges, Fox's case might have been taken to justify a conclusion that a venture which involves some substantial physical change in property—in Fox's case the realisation of land by draining and filling—is an isolated business venture. And if the view of Mason J. in relation to Scottish Australian Mining had been the view of both judges, that case might have been taken to justify a conclusion that a venture which involves more than basic development is an isolated business venture, though there would remain room for argument as to what is basic development. Under modern conditions of the grant of development approval, the provision of roads, footpaths and services of water and electricity would be seen as basic. The building of houses may go beyond basic development, though possibly not where they are limited in number in relation to the size of the development. The dedication of land for churches and parks may go beyond basic development.

2.504 While most of the cases that have applied the advantageous realisation principle have been concerned with land development, the principle has a wider operation. Jacobs J., it will be seen, was ready to apply the advantageous realisation principle to the realisation of options by the subscription for shares in the exercise of the options and the sale of the shares: Macmine Pty Ltd (1979) 53 A.L.J.R. 362 at 376.

2.505 It is apparent from his judgment in Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355 at 371, more especially his views on Fox's case and Scottish Australian Mining that Mason J. would find the concept of an isolated business venture more easily satisfied than would any other judge. At one stage in his judgment (at 376) he made the suggestion that Jones v. Leeming was not correctly decided, and that an acquisition of property with a subjective purpose of profit making by sale and a sale of that property is an isolated business venture. Jones v. Leeming, he thought, was rejected by the later decision in Edwards v. Bairstow [1956] A.C. 14. It has already been noted that Gibbs C.J. and Mason J. expressed the view that the specific provisions of s. 26(a) (now s. 25A) and s. 52 have no operation
where the field is covered by the concept of an isolated business venture. If this is the correct view, and *Jones v. Leeming* is rejected, s. 25A will be stripped of most of its significance. The correlation between the isolated business venture concept and s. 25A is considered in [3.4]–[3.11] below.

**Proposition 15: A gain which is compensation for an item that would have had the character of income, or for an item that has the character of a cost of deriving income, has itself the character of income**

2.506 There will be overlaps between the operations of Propositions 14 and 15, the extent of the overlaps depending on how wide the notion of “compensation” is taken to be. It is arguable that where a taxpayer has realised an asset by disposing of it to another, and has received an amount as proceeds of that realisation, the only relevant proposition, of the two propositions, is Proposition 14 expressing the gains from business principle. There is no case which applies the compensation principle in a realisation of an asset situation, as distinct from a surrender of rights situation. But there is clear authority that the principle is relevant in a surrender of rights situation: *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144 and *Dickenson* (1958) 98 C.L.R. 460. And there is no reason why the compensation principle should apply in a surrender of rights situation, but not in a realisation of rights situation. It will be seen that the application of the compensation receipts principle in the facts of *Cliffs International Inc.* (1979) 142 C.L.R. 140 affords a reason for concluding that the series of receipts by Howmet and Mt Enid in respect of the realisation of the shares they held in Basic were income receipts.

2.507 The compensation principle has an operation in circumstances where Proposition 14 could not be applicable, because there is no business of any kind relevant to the business gains principle: *Phillips and Dixon* (1952) 86 C.L.R. 540 are authority. It might, however, be noted that in the judgment in *Carapark Holdings Ltd* (1967) 115 C.L.R. 653 there is a passage which seems to assume that the compensation principle is simply a special application of the business gains principle, and that it has no independent operation. It was said (at 663):

“Accordingly the insurance moneys which the appellant received in respect of the death of Williams must be considered as having been gained in the course of its business, using ‘business’ in the broad sense which makes it relevant to the tax problem, that is to say as meaning the continuous course of conduct which the appellant was following for the derivation of income.”

The taxpayer company was a holding company and had no business in a sense
relevant to the gains from business principle, and this, one would think, was the only
sense in which business was “relevant to the tax problem”.

2.508 Proposition 15 is framed in the language of “gain”. A compensation
receipt is income only to the extent that it involves a gain. Where a
compensation receipt substitutes for a revenue asset that has been realised,
or for a revenue asset that has been destroyed, it is the excess of
compensation over the cost of the asset that is income, or if the
compensation is less than cost, it is the shortfall that is deductible as a loss
under s. 51. At least this is the ordinary usage principle. Reference has
already been made to the specific provisions of the Assessment Act in ss
28ff. and s. 51(2) in relation to trading stock as defined in s. 6 which, by
implication, displace the principle. Those provisions are more closely
considered in Chapter 14 below. Where the trading stock provisions do not
apply, the principle is unaffected. If Australasian Catholic Assurance Co.
Ltd (1959) 100 C.L.R. 502 had been concerned with an insurance receipt,
the block of flats having been destroyed by fire, the receipt could only have
been income to the extent of any surplus over cost of the building. There
would, no doubt, have been problems in identifying the cost of the building
as distinct from the land and building, and it may have been necessary to
apply a profit emerging principle, explained in Chapter 12 below, so that
the insurance receipt is to be regarded as part of the proceeds of realisation
of the land and building. But, however approached as a matter of tax
accounting, the principle remains applicable that it is only the gain or profit
element in the insurance receipt that is income.

2.509 The assertion of principle in the last paragraph requires qualification
where there is a realisation of an asset, or there is an insurance recovery or
a recovery of damages in respect of an asset, and a number of receipts are
held to be income as substituting for the income receipts that would have
been derived had the asset been retained, or retained undamaged. It seems
that the receipts will be income as to the whole of their amounts, and in
this there is a contradiction of the principle that gain is an essential quality
of income. To avoid that contradiction, in the case of a revenue asset, there
should be a subtraction, against each receipt, of part of the cost of the asset
so that only the profit emerging is brought to tax. Where the asset is not a
revenue asset, there should be a subtraction in the same manner of the
value of the asset at the time it was realised or damaged, in order to avoid
the contradiction, and to protect the principle that a capital gain is not
income.

Compensation received on the realisation of an asset
2.510 If the asset realised is a revenue asset of a business, the proceeds, to the extent of any gain, will be income under the business gains principle and under the compensation receipts principle. Where the asset is not an asset of any business, or where it is a capital asset of a business, the compensation principle may hold a gain to be income which would not be income under the business gains principle.

2.511 In theory, a single sum receipt in respect of an asset that is not a revenue asset could be income under the compensation principle. It is, perhaps, unlikely. Reference has already been made to the economists' view that the value of any asset is simply the present value of the flows of income it might be expected to produce. If the proceeds of realisation of any asset are overtly calculated as compensation for the flows of income which the asset would have produced had it been retained, there is some risk that the proceeds will be held to be income. Clearly there is risk of confounding the income tax law. The courts have been wary of going too far with the economists. The judgment of Lord Macmillan in the House of Lords in *Van den Berghs Ltd v. Clark* [1935] A.C. 431 insists on a distinction between compensation for an asset and compensation for the income flows the asset would have produced. The fact that the value of an asset is calculated by reference to the probable income flows, we are told, does not mean that the value received by the taxpayer substitutes for those income flows. To argue that it does, Lord Macmillan insisted, is to confuse the measure of a compensation receipt with the quality of the receipt. The distinction, as drawn by Lord Macmillan, is referred to by both Sugerman J. and Walsh J. in *Williamson v. Commissioner of Railways* [1960] S.R. (N.S.W.) 252 though, in applying it, they arrive at opposing conclusions. It will not easily be concluded that compensation is for the anticipated flows of income when it is received in one amount in advance of any such flows. A conclusion that a lump sum is for the flows may depend, in a damages compensation situation, on the way the taxpayer has framed his claim to damages: *Robert v. Collier's Bulk Liquid Transport Pty Ltd* (1959) 33 V.L.R. 280.

2.512 The cases just referred to involve damages compensation. There is no case which has treated a single amount on realisation of an asset as compensation for future income flows, but the possibility cannot be excluded. In the passage in *Van den Berghs* in which Lord Macmillan drew the distinction between measure and quality, the possibility is not excluded (at 442):

“If the appellants were merely receiving in one sum down the aggregate of profits which they would otherwise have received over a series of years the lump sum might be regarded as of the same nature as the ingredients of which it was composed. But
even if a payment is measured by annual receipts, it is not necessarily in itself an item of income. As Lord Buckmaster pointed out in the case of the *Glenboig Union Fireclay Co. v. Commissioners of Inland Revenue* [(1922) 12 T.C. 427 at 464]：“There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test.””

2.513 If the single amount receipt is held to be income, it will presumably be income as to the whole of its amount and there will be the prospect of contradiction of the principle that gain is an essential quality of income. Where the asset is a revenue asset, there should be a subtraction of the cost of the asset. Where it is not a revenue asset, there should be a subtraction of the value of the asset at the time of realisation, if the conflict is to be avoided and the principle that a capital gain is not income is to be protected. The subtraction of value will in most cases mean that there is no amount of income brought to tax. An amount calculated as the present value of the future flows of income from the asset and the amount of the value of the asset, may be expected to be the same.

2.514 The authorities indicate that a series of receipts is likely to be regarded as for the income receipts that would have flowed to the taxpayer had he not disposed of the asset. It will be recalled that a series of receipts in respect of an exclusive licence and, presumably in respect of an outright disposition, of an item of commercial or industrial property have been held to be income as gains derived from property: *I.R.C. v. British Salmson Aero Engines Ltd* [1938] 2 K.B. 482 and *Murray v. I.C.I. Ltd* [1967] Ch. 1038 were considered above in [2.346]–[2.353]. The authorities offer no detailed guidance on the extent of the recurrence that is necessary to make the series of receipts income. The suggestion was made above that recurrence extending over the whole life of the rights disposed of—it may be an exclusive licence for 10 years—may justify a conclusion that the receipts are for the use of the asset, and on this basis income derived from property.

2.515 Recurrence of receipts has a like significance in requiring that the receipts should be treated as compensation for the income that would have been derived from the property, had it not been disposed of. Indeed the gains from property principle and the compensation receipts principle, in this context, coalesce: any difference between them is merely verbal. Two possible explanations of how the receipts by Howmet and Mt Enid in *Cliffs International Inc.* (1979) 142 C.L.R. 140 might be held to be income have been debated in [2.333] above. One of these is that they were income as periodical receipts, by which Howmet and Mt Enid shared in the profits generated by the property they had sold. The second explanation would be
that they were income derived from property. This and the third explanation now suggested—that they were compensation for income flows—may be regarded as the same explanation. In fact in *Cliffs International* the receipts were to extend over the whole period of life of the rights disposed of; at least they can be so regarded if one treats the disposal of the shares in Basic as a disposal of the mining rights held by Basic. If recurrence ever justifies a conclusion that receipts are income within any of the periodical receipts, gains from property or compensation receipts principles, the recurrence would justify such a conclusion on the facts of *Cliffs International*. Recurrence extending over a less period than the life of the rights disposed of may be enough to engage the periodical receipts principle. To engage the gains from property and compensation receipts principles, however, it may be that the series must extend substantially over the life of the asset.

2.516 Where the series of receipts are income under the periodical receipts principle, there is an acknowledged contradiction of the principle that gain is an essential quality of income. There is some mitigation, however, by s. 27H where that section applies. Where the series are income as gains from property or compensation receipts, there is the prospect of contradiction unless there is a subtraction in determining the amount of income, as explained in [2.513] above. The mitigation by amortisation of costs provided for in Div. 10B of Pt III, examined in [10.212]ff. below is available only where the asset is an item of commercial or industrial property, and will not in any event have any application in the circumstances now considered. There may be mitigation in the operation of s. 59 of the depreciation provisions considered in [10.188]ff. below. But those provisions have limited application.

2.517 The possibility that an amount received on realisation of an asset will be income as compensation for outgoings on revenue account incurred in bringing the asset into existence cannot be excluded. In National Commercial Banking Corp. of Australia Ltd (1983) 83 A.T.C. 4715 the Commissioner argued that an amount received by a bank from another bank, on the admission of the latter bank to the “Bankcard” scheme of which the taxpayer was a member, was received in compensation for outgoings on revenue account incurred by the taxpayer bank in building up the Bankcard scheme operations. The Federal Court held that the finding of the trial judge that the amount received had only in part been calculated by reference to outgoings that had been incurred on revenue account, and that it was impossible to dissect the amount received so as to attribute a part to outgoings on revenue account, prevented a conclusion that the whole or any part of the amount received was income. This aspect of the decision is
referred to in [2.570] below. But the possibility is raised that, in an appropriate case, it may be held that a receipt which is akin to a receipt on a partial disposition of goodwill is a receipt of income as compensation for outgoings on revenue account incurred in building up the asset realised. The manner in which the distinction between a receipt for the asset and a receipt in compensation for the outgoings on revenue account might be made is not explored in the case. Recurrence of receipts could not have significance as it has in indicating that receipts are for income that would have been derived.

Compensation received on the surrender of rights

2.518 The issues of principle in relation to receipts for the surrender of rights parallel the issues detailed under the last heading. Indeed Van den Berghs Ltd v. Clark [1935] A.C. 431 and Glenboig Union Fireclay Co. Ltd (1922) 12 T.C. 427, which are referred to there, are surrender of rights cases.

2.519 An illustration of the operation of the gains from property principle in a series of receipts situation involving a surrender of rights, may not be readily imagined. Aktiebolaget Volvo (1978) 78 A.T.C. 4316 may afford an illustration. The surrender of rights in that case had, as its consequence, the making of rights available to another. The restrictive covenant left the beneficiary of the covenant with the exclusive use of the taxpayer's goodwill in Australia. The series of payments by the beneficiary to the taxpayer might thus be seen as gains derived by the taxpayer from property. And they might equally well be seen to be compensation for the gains that the taxpayer might have made by itself exploiting that goodwill. Again the gains from property principle and the compensation receipts principle coalesce.

2.520 Two cases concerned with surrender of rights, raise the question of the scope of the recurrence that will attract the compensation receipts principle. They are Dickenson (1958) 98 C.L.R. 460 and C. of T. (Vic.) v. Phillips (1936) 55 C.L.R. 144. In Dickenson there were two sums, each of £2,000, paid on successive days. The possibility that the receipts were, in the words of Dixon C.J., “compensatory for the loss of future profits” that the restrictive covenants might involve, was considered but rejected. In this regard, all members of the majority drew attention to the fact that the receipts were not “recurrent”. Thus, Dixon C.J. said (at 475): “There is nothing recurrent, in the nature of the payment”. Williams J. said (at 483): “If the consideration takes the form of recurring payments, these payments may well be considered to be a quid pro quo for the profits the covenantee
would have made if he had not withdrawn from such activities and be income.” Kitto J. observed (at 492): “The consideration for it was paid to the appellant in two sums but was otherwise non-recurring.” If the agreement had required that payments continue substantially over the period of the restrictive covenant, there would have been room for the compensation receipts principle, on the authority of Phillips. The payments in respect of surrender of rights under the service agreement were, in that case, not only the estimated amounts that the taxpayer would have received under the service agreement, but were to be made at the same times as amounts would have been received under the service agreement. Dixon and Evatt JJ. said (at 156): “But, where one right to future periodical payments during a term of years is exchanged for another right to payments of the same periodicity over the same term of years, the fact that the new payments are an estimated equivalent of the old cannot but have weight in considering whether they have the character of income which the old would have possessed.”

2.521 The application of the compensation receipts principle in a surrender of rights situation, as in *Van den Berghs, Glenboig, Dickenson* and *Phillips*, raises issues in regard to the principle that gain is an essential quality of income. If a subtraction is to be allowed to reflect the cost or value of the rights surrendered, there will be problems of fixing a cost or value. In this context, the notion of gain is itself tested. The economist's concept of accretion to economic power is painted with a broad brush. He might be uncertain, if asked to define the extent of an accretion where freedom of action or rights under a contract to perform services are surrendered for consideration. There is much to be said for a view that a receipt for giving up rights under a service agreement is, substantially, pure gain. In *Phillips* the receipts were the equivalent of the amounts that would have been received had services been performed under the contract. They were received though the services had not been performed. If the service agreement is to be seen as an asset notionally realised by the surrender, the value of that asset, even if the rights to serve were transferable, would not be the present value of the amounts that could be earned. In any event the appropriate subtraction will not always be the value of the service agreement. In [2.378] and [2.384]–[2.385] above the possibility was raised that costs of obtaining an employment contract are deductible because the employment contract is a revenue asset of a business of providing services under contracts of employment. And the possibility was also raised that the costs of obtaining an employment contract are deductible, even though there is no business of providing services, as costs of a non-structural contract of service, rewards for which are income. Where the service
agreement is a revenue asset or a non-structural asset, there can be no question of subtracting the value of the agreement from the proceeds of realisation: the whole proceeds are an income gain. Where, however, the service agreement is a structural asset, as it normally will be, or the case involves the surrender of freedom of action which in the circumstances is a structural asset, there is in theory a need to subtract value from the proceeds that are held to be income as compensation receipts. The determination of that value, more especially where freedom of action is surrendered, is a daunting prospect and should not, in the view of this Volume, be attempted. Valuing freedom of action would require an excursion into matters that are irrelevant to any commercial idea of value. To say that we are valuing “human capital” does not assist. It merely identifies the problem.

2.522 There are problems of determining cost or value in a Van den Berghs or Glenboig situation if the compensation receipts situation will, in the circumstances, given an income character to receipts. In a Van den Berghs situation they would be no less than in a Phillips situation. In a Glenboig situation the problem is manageable. The protection of the principle that income involves a gain will require a deduction of the value of the right sterilised, which would be the value of the mineral as it lies in the ground. That value, if market value is appropriate, would be small. The questions raised in this and the last paragraph, test to the limit the notion of gain and the distinction between income gain and capital gain. The logical culmination of the Simons concept of gain ([1.46]ff. above) would require an annual valuation of all assets, including an employment contract and human capital, though Simons might have baulked at the former and retreated to a position that would confine gain to realised gain. And he might have adopted an exception that would put gains in human capital out of reckoning. The notion of a realised gain requires an exclusion of gains already realised and outlaid in producing proceeds in which a further gain may be realised. And if a distinction is drawn between an income gain and a capital gain the calculation of a realised income gain requires an exclusion of a capital gain that has not been realised that is outlaid in producing proceeds which are to be treated as an income gain.

Compensation under statute or insurance

2.523 Compensation under a statutory compensation scheme, or under an insurance policy, where the compensation relates to some physical asset such as land or a chattel, raises problems of analysis parallel with those already considered in dealing with compensation on the realisation of an
asset. Characterising the compensation as for the asset or for the income flows that would have been derived, in that context, centred on the terms of any agreement—whether it provided for calculation of the compensation by reference to the amount of the anticipated flows, and whether the compensation was payable in a series of amounts. When the receipt is under a statutory provision or under an insurance policy, characterising must centre on the statutory provisions or the insurance policy.

2.524 In *Wade* (1951) 84 C.L.R. 105 the statutory compensation related to livestock that were trading stock, and thus were revenue assets. Characterising was therefore not complicated by any need to distinguish compensation for the asset from compensation for income flows. Characterising an insurance receipt in the like circumstances would be similarly uncomplicated.

2.525 Where there is a capital asset to which the compensation receipt relates, characterising will require a determination of the function of the compensation—whether to compensate for the asset or for the income that would have been derived from the asset. There is a question whether some objective or subjective purpose will explain that function. In the case of statutory compensation, the provisions of the statute may reflect a purpose objectively determined. The provisions of the statute were explained in the judgments of the High Court in *Wade* though, the assets being revenue assets, no analysis of purpose was called for. The case is valuable primarily for its formulation of principle in the judgment of Dixon and Fullagar JJ. (at 112): “moneys recovered from any source representing items of a revenue account must be regarded as received by way of revenue.” In *Higgs v. Wrightson* [1944] 1 All E.R. 488 the taxpayer asserted that the function of a ploughing grant he had received from the Crown was compensation for a capital loss he had suffered by the ploughing. The ploughing of pasture land, it was said, partly destroys the fertility of that land. Macnaughton J. rejected the taxpayer’s submission after an examination of the terms of the relevant legislation. In neither case was there any suggestion that the function might have been determined by going behind the legislation to some subjective purpose of parliament reflected in the legislative history.

2.526 In *Slaven* (1984) 84 A.T.C. 4077, however, the Federal Court did make some search for the subjective purposes of Parliament. In *Tinkler* (1979) 79 A.T.C. 4641 the taxpayer had received a number of amounts under the Victorian *Motor Accidents Act* 1973. The amounts were paid as compensation in respect of physical injuries suffered in a motor accident. The court concluded, after a review of the terms of the *Motor Accidents Act*, that the payments were in substitution for income which the taxpayer
would have earned were it not for the accident. The provisions of the *Motor Accidents Act* were thereafter amended so that the compensation under that Act was now described as compensation for loss of earning capacity. The Federal Court in *Slaven* made reference to the second reading speeches in relation to the amendment, and observed (at 4084) that “it is plain beyond argument that the principal problem which the [amending] Act was intended to overcome was the attraction of income tax to benefits paid under the Act”. The court further observed (at 4085): “The Parliament of Victoria cannot determine by its own legislation whether the receipt of a statutory payment answers the description of income or capital in the hands of the recipient . . . But the purpose of a statutory payment, as disclosed by the terms of the statute itself, must be a powerful, though not conclusive, aid to the determination of the character of the payment and in particular as to whether its receipt constitutes income in the hands of a taxpayer.” The passage last quoted shows a return to a more conventional approach to statutory interpretation than that suggested by the earlier reference to the Ministers' speeches. And it would appear that characterisation ultimately depends not solely on the purpose of the statute, but on a combination of factors, and the language of “function” of the receipt by the taxpayer remains appropriate. Among the circumstances considered in *Slaven* was the fact that several payments had been made to the taxpayer in respect of the injury. A series of payments may indicate that the function of the payments is to compensate the taxpayer for income he would have earned were it not for the accident, but it seems that it is no more determinative than is the purpose of Parliament.

2.527 There is some suggestion in *Carapark Holdings Ltd* (1967) 115 C.L.R. 653 that the subjective purpose of the taxpayer in effecting insurance may determine the function of the compensation received under that insurance. The court observed that no form of proposal had been submitted by the taxpayer at the time when a cover note was issued, and the insured event occurred before any formal proposal had been made. And the court observed that no information was available as to anything that passed between the taxpayer and the insurance company in the course of the negotiations for the cover. The court also looked to the manner in which the taxpayer applied the money received under the policy, as throwing light on “the purpose for which the taxpayer entered into [the] contract” (at 660).

2.528 *Carapark* also carries some suggestion that the deductibility of a premium, or, more likely, the claim to deduct the premium, bears on the characterisation of a receipt under a policy. The suggestion probably amounts to very little—it is no more than what might be inferred from the
statement in the case that the taxpayer had claimed a deduction of the premium. The claim to deduct may be evidence of the taxpayer's subjective purpose, though it is not easy to see what significance it might have. However, any principle that would draw a conclusion from deductibility of a premium that a receipt under the policy is of a revenue character, cannot be accepted. It will be seen in [6.217]–[6.219] below that a premium on insurance of factory premises used by the taxpayer to produce income is probably deductible. It would be a bizarre conclusion that compensation received under the policy must be income. The principal judgment in the Federal Court in *D. P. Smith* (1979) 79 A.T.C. 4553 also carries a suggestion of a connection between deductibility and the receipt being income. In this instance, however, the suggestion is that the income quality of the receipt is relevant to the deductibility of the premium. The suggestion is repeated in the High Court judgment: (1981) 147 C.L.R. 578.

2.529 The High Court in *Carapark* (at 662–663) speculated on what the function of the insurance might be, indicating that only two possibilities were “worth considering”:

“One is that when the insurance was being negotiated the motivating consideration on the part of the appellant was that in any of the events insured against the receipt of the policy moneys would place the appellant in a position to do exactly the kind of thing it did in this instance, namely to extend an appropriate degree of generous treatment to the employee or his dependants. If any such notion existed, it was left to be further considered when the time should arrive. The only other possibility seems to be that as regards employees of subsidiaries the insurance was effected in order that in any of the events insured against the appellant should receive money to take the place of that which it would otherwise have derived from a continuance of the services of the employee to the subsidiary.”

The insurance had been taken out by a holding company against death by air accident of a senior employee of a subsidiary. The possibilities, as so framed, suggest subjective purpose.

2.530 The court's statement of principle is however framed in the language of objective purpose. It said (at 663):

“The reasons may be summarised by saying that, in general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt which the event insured against has prevented from arising, or of any outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by considerations of morality or expediency.”

At the same time, reference elsewhere in the judgment (at 663) to “the true purpose” (suggesting subjective purpose), and the statement (at 664) that “the purpose which has to be considered in determining the nature of
the receipt . . . is the purpose which in actual fact the insurance serves” (suggesting objective purpose), leave the question of the manner of determination of the function of insurance unresolved.

2.531 One would think that a determination by reference to subjective purpose at the time of effecting insurance is unsatisfactory. If the employee had left the taxpayer's service at the time he was killed in the accident, the conclusion reached in Carapark that the receipt was income could hardly have been appropriate. The detailed examination by Menzies J. in Development Underwriting Ltd (1971) 71 A.T.C. 4125 of the circumstances in which the policy in that case was taken out was directed to determining the purpose of the taxpayer in effecting the insurance. His conclusion was that the policy was taken out so that the taxpayer might have funds with which to repay a loan on the death of the life insured and he held that the proceeds of the policy were therefore not income. Menzies J. admitted evidence to the effect that a deduction had been claimed of the premiums paid on the policy. Clearly he thought this was a relevant fact in determining the taxpayer's purpose, but it did not displace the inference he drew from other evidence.

2.532 Toohey J., in delivering the principal judgment in the Federal Court in D. P. Smith (1979) 79 A.T.C. 4553, observed (at 4556) that the purpose spoken of in Carapark is “a more objective one” than the purpose that is relevant to s. 26(a) (now s. 25A(1)). The taxpayer had received monthly payments under a personal disability insurance policy following an injury in a traffic accident. Toohey J. concluded, primarily from the terms of the insurance policy but without excluding the relevance of other circumstances, that “the purpose served by the insurance policy was to fill the place, if only in part, of . . . earnings [as an employed medical practitioner]”. In the High Court in D. P. Smith (1981) 147 C.L.R. 578 the assumption appears to be that the determination of function is solely a matter of objective inference from the terms of the policy. The court approved (at 583) a conclusion that had been reached by Wickham J. “from his review of the [insurance policy]”.

2.533 In Carapark there was only one payment. In D. P. Smith there were monthly payments over four months. In the view of Toohey J. “the entitlement to regular monthly payments is important although not decisive”: (1979) 79 A.T.C. 4553 at 4557. The contribution that recurrence of payments may make to a conclusion that compensation receipts are income is thus recognised.

2.534 There is authority that would indicate that where property is insured and that property is damaged but not destroyed, it is a possible inference that the function of the payment of compensation was to substitute for the
loss of income suffered during the time the property was under repair. The inference will be the stronger if there is a distinct payment under the policy to cover the costs of repair. These are implications, in the insurance context, of the decision in *London & Thames Haven Oil Wharves Ltd v. Attwooll* [1967] Ch. 772, a case concerned with the recovery of damages in satisfaction of claims arising from damage done by a ship to a wharf owned by the taxpayer. The Court of Appeal, in holding that part of the amount received was income as compensation for profits lost during the time the wharf could not be used, distinguished *Glenboig Union Fireclay Co. Ltd* (1922) 12 T.C. 427 on the ground that the latter case was concerned with permanent deprivation of the capital asset used by the trader for purposes of his trade: the trader had abandoned that part of his trade which involved the use of the capital asset of which he had been deprived. In the words of Diplock L.J. in the *London & Thomas* (at 818):

> “Even if the compensation payable for loss of the capital asset has been calculated in whole or in part by taking into consideration what profits he would have made had he continued to carry on a trade involving the use or exploitation of the asset, this does not alter the identity of what the compensation is paid for, to wit, the permanent removal from his business of a capital asset which would otherwise have continued to be exploited in the business: see the *Glenboig* case.”

2.535 The same idea is expressed in the language of fruit and tree by the High Court in *D. P. Smith* (1981) 147 C.L.R. 578 at 583:

> “If the ability to earn is the tree, and income the fruit thereof, a policy of insurance against impairment of the fruit-bearing capacity of the tree may well take the form of providing the fruit until such time as the tree recovers its proper role. The degree of correspondence, if any, between the moneys payable under the policy and the actual pecuniary loss of revenue suffered by the insured is a relevant factor, but it is not necessary to look for an indemnity measured with any precision against the loss. Any fruit is better than none, whether or not it represents adequate compensation for the loss.”

2.536 The references to *Carapark Holdings Pty Ltd* (1967) 115 C.L.R. 653 and *D. P. Smith* in the survey of how the function of an insurance receipt is to be determined has taken the discussion into areas where the insurance receipt is not directly related to the loss of an asset. In *Carapark* it might have been argued that the right to the services of the deceased employee was a structural asset, an argument that might be given more colour by an insurance policy which purports to give “key-man” insurance. The argument would seek to bring the circumstances within *Van den Berghs Ltd v. Clark* [1935] A.C. 431. It was not however attempted in *Carapark*. An argument was made by counsel for the taxpayer in *D. P. Smith* in the
High Court that the moneys received under the insurance policy represented payments made for the loss of a capital asset, namely “the taxpayer's ability to work as a medical practitioner, carrying with it the capacity to earn income” (at 582). The conclusion of the court was that the purpose of the policy and thus the function of the compensation, was to provide a monthly indemnity against the income loss arising from the inability to earn. Such a conclusion, like the conclusion as to the function of the insurance in Carapark, makes the character of the asset as a structural asset irrelevant.

2.537 In cases where the framework of loss of an asset is inappropriate, the choice in determining function will be between (i) substitute for a revenue item of receipt or outgoing, (ii) substitute for a non-revenue item of receipt or outgoing, and (iii) not a substitute at all. In Carapark the choice made was substitute for the dividends that might have been derived by the holding company had the subsidiary continued to have the advantage of the employee's services, or for the revenue expenses associated with the loss of the employee. The alternative that the receipt was a windfall gain was rejected. In D. P. Smith there was some basis for arguing that the receipts were not a substitute for any item: the amount received was not measured with any precision against the loss. If this argument had been accepted it would have been necessary to inquire whether the receipts were income within the periodical receipts principle, but they would not have been income as compensation receipts.

2.538 In Carapark it was considered that a function of the insurance receipt was to put the taxpayer “in a position to do exactly the kind of thing it did in this instance, namely extend an appropriate degree of generous treatment to the employee or his dependants” (at 662), and that this would be enough to give the receipt an income quality. The statement of principle in the case may be thought to require a more specific function for the receipt: it must fill the place of an “outgoing which has been incurred on revenue account in consequence of the event insured against, whether as a legal liability or as a gratuitous payment actuated only by considerations of morality or expediency” (at 663). The amount received was in fact settled by the taxpayer on terms that provided for an annuity for 10 years to be paid to the widow of the employee, charged on the capital and income. On the expiration of the 10 years any amount of capital or income not used in paying the annuity was to be returned to the taxpayer. Whether or not the settlement of the insurance receipt would be an “outgoing on revenue account”, words which assume an accounting concept of deductibility, may be doubted. The inference may be that the High Court did not intend that the operation of the principle should depend on the actual use of the
insurance money. To require that there be actual use would encourage the taxpayer receiving an amount as in *Carapark*, to see to it that the money received was not used in accordance with the function it was intended to serve. The actual use of the money or, indeed, the use of other money to effect a revenue outgoing related to the insured event should not be a condition of the operation of the principle, however significant it may be in determining the function of the insurance receipt.

2.539 If an actual use of the insurance money, or some other money, to effect an outgoing on revenue account is necessary, there will be problems as to what is “an outgoing on revenue account”, and how far this concept may differ from the concept of deductibility expressed in s. 51. The question has been raised above whether the actual use in *Carapark* was “on revenue account”. *Ransburg Aust. Pty Ltd* (1980) 80 A.T.C. 4114 may be thought to be authority that the actual use did not involve a deductible expense under s. 51. *John Fairfax & Sons Pty Ltd* (1959) 101 C.L.R. 30 affords another illustration of what may be an outgoing on revenue account—legal expenses associated with the acquisition of a controlling interest in another company—which, as was held in the case, was not deductible under s. 51.

**Compensation received as damages**

2.540 The operation of the compensation principle to a receipt by way of damages will follow the analysis under the last heading. *London & Thames Haven Oil Wharves Ltd v. Attwooll* [1967] 1 Ch. 772, considered under the last heading, is in fact a damages case.

2.541 The subjective purpose of the taxpayer in effecting insurance has no parallel in the damages compensation situation. But the roles of subjective purpose and objective inference of purpose, and the relevance of the actual use of the compensation moneys, are again raised. There is a question, perhaps especially relevant in the present context, but not without relevance also in realisation, surrender of rights, and insurance contexts: how far is the form of a damages award, or an agreement settling a claim for damages, definitive on the issue of function? *Dickenson* (1958) 98 C.L.R. 460, in the surrender of rights context, is authority that a broad view is to be taken and that the form chosen—in that case receipts for a restrictive covenant—is not definitive. In *Carapark* and in *London & Thames Haven Oil Wharves* there was no element of form that might have been regarded as definitive. *Allsop* (1965) 113 C.L.R. 341, yet to be considered, may suggest that form is definitive. Observations on form and substance made earlier in [2.420]–[2.428] above, are relevant here.
It would be assumed that a single sum award for economic loss arising from personal injury is not income as a compensation receipt. There is, in any case, a problem of dissection or apportionment, a matter considered below, if the amount for economic loss is not distinguished in the award. The view that the damages award for economic loss is not income, relies on authorities which say that the damages are awarded for loss of earning capacity, and that this is a capital asset. These authorities begin with Paff v. Speed (1961) 105 C.L.R. 549, (esp. per Fullagar J. at 559). They are confirmed by statements in the judgment of Barwick C.J. in Cullen v. Trappell (1980) 146 C.L.R. 1 and in the judgment of the Federal Court in Slaven (1984) 84 A.T.C. 4077, where the authorities are collected. The fact that the damages are calculated by reference to the earnings the taxpayer might have derived if he had not lost the capacity to earn, does not displace the conclusion that their function is to compensate for the loss of capacity. In this context, the significance of calculation by reference to profits is different from what it may be in cases such as Glenboig Union Fireclay Co. v. I.R.C. (1922) 12 T.C. 427 and C. of T. (Vic.) v. Phillips (1936) 55 C.L.R. 144. The comments made above in [2.521]–[2.523] in regard to Glenboig and Phillips require some elaboration. The fireclay in Glenboig may be regarded as an asset. And so far as the calculation of compensation simply reflected what would have been paid by another for the opportunity to mine the deposit of clay, the compensation may be said to be for the asset. But where the calculation reflects profits the taxpayer might have made by mining and selling the clay—the value to be added by those activities—the compensation may well be regarded as for those profits. This is not to confuse quality and measure of compensation but to indicate the bearing measure may have on quality. The compensation is for the potential profits to be made by exploiting the asset. Such a significance cannot be given to a like calculation in the economic loss for personal injury situation, because the asset for which the damages may be said to be compensation embraces the capacity to make those profits. The actual decision in Glenboig may turn on the fact that the clay was in situ and the taxpayer was already engaged in exploiting other parts of the deposit. The asset might then be regarded as including the capacity to exploit. Compensation in respect of raw materials used by a manufacturer which can be readily replaced might fairly be said to be for the profits, if it is calculated by reference to profits. The asset itself does not include a capacity to exploit which may be said to have been lost. The point will not of course be significant in the case of trading stock as it is in a Glenboig situation. The trading stock and, one would think, the capacity to exploit it are revenue assets.
2.543 It follows from analysis of this kind that the compensation in *Phillips* might have been held to be for the salary receipts even though it had been received in a single sum. The taxpayer's capacity to earn was not lost by his surrender of rights under the service agreement. If a contract to perform services were assignable, no buyer would pay for that contract the estimated profits to be made from performing services under the contract. If he has paid that amount, there will be no room for him to gain by performing the services, and the function of the payment would need to be explained in terms other than consideration for the contract. The conclusion, here suggested, that a golden-handshake receipt calculated by reference to the earnings that would have been derived are ordinary usage income as compensation receipts, will not be generally accepted. And Subdiv. AA of Div. II of Pt III and the words added to s. 25(1) referred to in [2.369] may have excluded the possibility of any judicial examination of the question. A golden-handshake receipt will, at least generally, be income as “an eligible termination payment” and its income character exclusively determined by ss 27B and 27C.

2.544 In applying the rule in *British Transport Commission v. Gourley* [1956] A.C. 185 in actions for damages, the Australian courts have had to decide an issue as to whether compensation receipts will be income, on a number of occasions. The decisions in regard to damages for economic loss in personal injury cases have already been mentioned. In *Pennant Hills Restaurants Pty Ltd v. Barrell Insurances Pty Ltd* (1978) 78 A.T.C. 4032 the Supreme Court of New South Wales expressed a variety of views on the question whether an award of damages against an insurance broker for failing to keep the plaintiff insured against workers' compensation liability, was income. The amount had been calculated by reference to payments the plaintiff would have to make under an Uninsured Liability Scheme. Reynolds J.A. thought the award was income by ordinary usage. Hutley J.A. thought it was income, not by ordinary usage, but under the specific provision in s. 26(j). Mahoney J.A. thought it was not income, whether by ordinary usage or under s. 26(j). The question whether the damages award was income was not argued in the High Court: (1981) 145 C.L.R. 625. The payments in *Barrell Insurances* would continue for a number of years, and indeed might cease to be revenue outgoings because the plaintiff's business had been discontinued. Whether receipts in respect of such outgoings are income by ordinary usage raises issues considered in observations on *Carapark Holdings Pty Ltd* (1967) 115 C.L.R. 653. Would an intention, or legal obligation undertaken, to pay an annuity to the widow have required a different conclusion in *Carapark* on the issue of compensation for a revenue outgoing? The deductibility, and, presumably,
the revenue character, of those payments would cease if the business were disposed of or discontinued. *Amalgamated Zinc (De Bavay's) Ltd (1935)* 54 C.L.R. 295 considered in [5.37]–[5.38] below is authority.

Receipts of voluntary payments

2.545 *Dixon* (1952) 86 C.L.R. 540 was considered above in [2.172]–[2.178] in dealing with periodical receipts. The case is also important as the source of authority for a proposition that a series of voluntary payments may be income as compensation receipts. That authority is in the judgment of Fullagar J., but the proposition is not inconsistent with the decisions of Dixon C.J. and Williams J. Fullagar J. said (at 568):

“What is paid is not salary or remuneration, and it is not paid in respect of or in relation to any employment of the recipient. But it is intended to be, and is in fact, a substitute for—the equivalent pro tanto of—the salary or wages which would have been earned and paid if the enlistment had not taken place. As such, it must be income, even though it is paid voluntarily and there is not even a moral obligation to continue making the payments. It acquires the character of that for which it is substituted and that to which it is added. Perhaps the nearest parallel among the many cases cited to us is to be found in *Commissioner of Taxes (Vic.) v. Phillips (1936)* 55 C.L.R. 144.”

*Dixon* is referred to in *Harris* (1980) 80 A.T.C. 4238 and in the Federal Court in *D. P. Smith (1979)* 79 A.T.C. 4553, but the extension of the compensation receipts principle to voluntary payments is not questioned.

2.546 There will be questions as to the circumstances which are relevant in determining the function of the payments, of the kind considered in [2.523] ff. in relation to compensation under statute or insurance.

A receipt which is a return of an outgoing

2.547 The impression that is left by the cases considered under earlier headings is that the compensation receipts principle has a very wide operation. However, *H. R. Sinclair & Son Pty Ltd (1966)* 114 C.L.R. 537 is authority for a limitation on the principle which would deny its relevance in what might be called a refund situation—the return of the whole or part of an outgoing. One would have thought that *Dixon, Phillips* and *Carapark*—indeed all the cases so far referred to in relation to compensation receipts—directed a conclusion that an amount paid and received as a refund substituted for the outgoing and was income, if the outgoing was on revenue account. Yet *Sinclair*, without reference to the compensation receipt cases, decided that there was no principle that a refund of an amount that was an allowable deduction is income. There had
been warning that the High Court would take such a view in observations made in Allsop (1965) 113 C.L.R. 341 referred to below. In Sinclair, Owen J. said (at 545):

“But the fact that the amounts so paid were properly claimed and allowed as deductions in assessing the company to tax in those earlier years does not determine the question whether the amount refunded is to be regarded as part of the company's assessable income for the year in which the refund was received. . . . But it does not follow that the amount refunded must therefore be regarded as part of the company's assessable income of the year in which the refund was made. I mention this because many of the arguments put to us by counsel for the Commissioner seemed to suggest that because the earlier payments had been allowed as deductions since they had been made in gaining the company's assessable income in those years, it necessarily followed that the refund was to be treated as a receipt of income. This, I think, is not the right approach. The real question is whether the amount received by way of refund was part of the company's assessable income for the year in which it was received.”

2.548 In fact the court held that the refund was income under the business gains principle, but that principle will not assist in producing what might be thought to be the correct outcome where there is no business. The refund may be of an outgoing deductible by an employee, or by a person deriving investment income. In any case, if the judgment of Taylor J. is emphasised, Sinclair is authority that the refund is income as a business gain only where there has been activity directed to the obtaining of the refund: it is not income where the refund has not been sought. Taylor J. said (at 544):

“[The taxpayer's] attempts—which in the end were successful—to obtain a refund of amounts which it contended had been exacted as the result of the misapplication of the formula were just as much an activity of the business as would have been an attempt to avoid an overcharge in the first instance and the amount recovered in the year ended under review must be taken to have formed part of the appellant's income for that year.”

2.549 There are references, in the judgments of Taylor and Owen JJ., to the specific provisions in ss 72(2) and 74(2), dealing with refunds in particular situations, which, in the words of Owen J. “appear to recognise that the refund of an amount which has been allowed as a deduction from the assessable income of an earlier year is not necessarily part of the assessable income in the year of receipt” (at 546). One would have thought this a slim basis of inference to displace a principle of the ordinary usage meaning of income otherwise recognised as part of the law. Those provisions, in any case, can be explained as concerned with refunds of deductions which may not be “outgoings on revenue account”, and therefore not covered by the
ordinary usage principle.

2.550 The operation of the compensation receipts principle in refund situations would contribute to a rational system of tax accounting. The amount claimed as an accrual or as an actual payment in an earlier year may have been greater than the correct amount of the liability. The Commissioner may have no power to amend the earlier assessment under s. 170. A power to bring a refund to tax is necessary to ensure correction. The view is put forward in [11.73]ff. below, that a liability acknowledged in response to a claim of right by a creditor will constitute an accrual, whether or not there was a legal liability to pay: legal liability is not an essential condition of an accrual of a liability or of a receivable. It would follow that the amount claimed as a deduction in the earlier year will have been correctly allowed, and no amendment could be made by the Commissioner.

2.551 In his judgment in Sinclair Owen J. referred to the judgment of Rowlatt J. in English Dairies Ltd v. I.R.C. (1927) 11 T.C. 597, where a proposition is asserted which would limit the operation of the business gains approach to dealing with refunds. Rowlatt J. said (at 605): “It is not a commercial operation to suffer extortion and it is not a commercial receipt to have the money handed back to you.” It may follow that any refund of an amount which the taxpayer was not legally liable to pay is not a business receipt. Thus in Allsop (1965) 113 C.L.R. 341, considered below in [2.567]–[2.569] a simple refund of the fees would not have been income of the taxpayer.

2.552 The operation of the compensation receipts principle in refund situations may not be finally foreclosed by Sinclair. Adjustments to amounts payable or to amounts receivable, giving rise to exchange gains and losses, have come to be recognised as income and deductible. A number of recent cases, beginning with International Nickel Aust. Ltd (1977) 137 C.L.R. 347, have confirmed earlier decisions of the High Court in this regard. It is a short step from treating an exchange gain as income to treating a refund as income.

Section 26(j)

2.553 Some part of the ordinary usage compensation receipts principle is expressed in s. 26(j). A submission that it was a code in relation to receipts of these kinds was put by the taxpayer in proceedings before the Board of Review in Carapark, but was not renewed in the appeal to the High Court.

2.554 The interpretation of the section is considered below in [4.204]ff. Two points might be made now. The first is that the section relates to a
“loss or outgoing which is an allowable deduction”. The ordinary usage principle, it will be recalled, is expressed in the language of loss or outgoing on revenue account.

The second point is that the section relates only to an amount received by way of “insurance or indemnity”. The consequence may be that its operation is confined to circumstances where there is a right to compensation under specific statutory provision, the general law or a contract, which already exists before the event occurs which gives rise to a claim for compensation. This would be the view of Hunt J. in Commercial Banking Co. of Sydney Ltd (1983) 83 A.T.C. 4208. The section could thus apply to a receipt in the circumstances of Higgs v. Wrightson [1944] 1 All E.R. 488 or Wade (1951) 84 C.L.R. 105 where a statute provided for a payment to the taxpayer if he took certain action or certain events occurred. It could apply to a receipt under the general law of damages. It could apply in the circumstances of Carapark Holdings Pty Ltd (1967) 115 C.L.R. 653 where an insurance policy provided for a payment if certain insured events occurred. But the section could not apply to a receipt on the surrender of rights as in C. of T. (Vic.) v. Phillips (1936) 55 C.L.R. 144, a voluntary payment by another as in Dixon (1952) 86 C.L.R. 540 or to a receipt under a contract which was entered into after the event in respect of which the payment is to be made, as in the Commercial Banking Co. or in Goldsbrough Mort & Co. Ltd (1976) 76 A.T.C. 4343.

In the latter case, s. 26(j) was held applicable by Walters J. The case concerned an adjustment received from the purchaser in respect of rates already paid by the vendor before entering the contract of sale that provided for the adjustment. Goldsbrough Mort was expressly rejected by Hunt J. in deciding the Commercial Banking Co. case. The Federal Court on appeal from the decision of Hunt J. (sub nom. National Commercial Banking Corp. of Aust. (1983) 83 A.T.C. 4715) did not find it necessary to consider this aspect of the judgment of Hunt J. The Commissioner had claimed that receipts by the taxpayer bank for allowing another bank to participate in an organisation—Bankcard—by which credit was provided for consumer purchases, was compensation for deductible expenses incurred in setting up the organisation. The Federal Court held that the amount received was not compensation for deductible outgoings, but a receipt for a partial vesting in another of assets and goodwill making up the Bankcard organisation. It could not therefore be within the ordinary usage principle or s. 26(j).

The conflict between Walters J. and Hunt J. remains unresolved. An ultimate resolution in favour of Hunt J. would not however affect the operation of the ordinary usage compensation principle in the
circumstances of Dixon or Phillips. And it would leave the possibility that the Goldsborough Mort decision could yet be supported on the basis of the ordinary usage principle.

**Dissection or apportionment of a compensation receipt**

2.558 Two decisions of the High Court—McLaurin (1961) 104 C.L.R. 381 and Allsop (1965) 113 C.L.R. 341—appear to have settled a principle that where a compensation receipt is in respect of items some of which are of a revenue kind and others not, and an amount in respect of the revenue items cannot be dissected or apportioned out of the receipt, no part of the receipt is income.

2.559 The principle thus settled contradicts the decision of the House of Lords in Tilley v. Wales [1943] A.C. 386. That case was referred to by the High Court in McLaurin, but no attention was given to the contradiction. It will be noted that in Tilley v. Wales the House of Lords took the view that an apportionment was proper because the Attorney-General had conceded that it should be made. Clearly the Attorney-General's concession could relieve the court of the obligation to decide whether or not an apportionment was proper only if the court took the view that the alternative to an apportionment was that the whole of the compensation was income. The judgment of Windeyer J. in National Mutual Life Association of Australasia Ltd (1959) 102 C.L.R. 29 is in line with the view taken by the House of Lords: Windeyer J. (at 50) was disposed to hold that if the premium could not be dissected or apportioned the consequence would be “not that no part of the total premium should be included in the assessable income, but that all of it should be”.

2.560 It is not clear whether, in McLaurin, the High Court regarded the compensation as having been given for the specific items in the taxpayer's claim or for damage to the structure of his business. Some of the property destroyed—sheep and other animals—was trading stock. But the argument is open, that the trading stock were capital assets in the context of the suffering of the loss. It will be seen in Chapter 14 below that trading stock disposed of in the sale of a business are, so far as ordinary usage principle is concerned, to be regarded as capital assets.

2.561 In Allsop there is, however, an assumption that McLaurin was concerned with compensation for the specific items in the taxpayer's claim, and the case is an authority as to when dissection or apportionment of compensation, so as to distribute it among the specific items, is appropriate.

2.562 Dissection, it would seem, is only appropriate where the taxpayer
can be said to have assented to several amounts in respect of specific items of an income character. It may be asked whether there would have been such assent in the circumstances of McLaurin if the Commissioner had written to McLaurin, after McLaurin had supplied particulars, offering to settle the case for a lump sum of £30,240, and McLaurin had accepted. And it may be asked whether there would have been such an assent if the Commissioner in making the offer of £12,350 had accompanied his offer by a statement setting out how he had arrived at the figure.

2.563 Assuming that a dissection is not appropriate, the question becomes whether there may be an apportionment so as to bring in part of the sum received in compensation as appropriate to the items of an income character. In denying that an apportionment was proper on the facts of McLaurin the High Court said:

“While it may be appropriate to [apportion] where the . . . receipt is in settlement of distinct claims of which some at least are liquidated, cf. Carter v. Wadman (1946) 28 T.C. 41, or are otherwise ascertainable by calculation: cf. Tilley v. Wales [1943] A.C. 386, it cannot be appropriate where the payment or receipt is in respect of a claim or claims for unliquidated damages only and is made or accepted under a compromise which treats it as a single, undissected amount of damages” ((1961) 104 C.L.R. 381 at 391).

The passage quoted is consistent with the view that the court did not think that any dissection or apportionment was proper in McLaurin, because the whole receipt had a homogeneous character—it was compensation for a capital asset. But if it is treated, as it was treated by the High Court in Allsop, as a decision on the possibility of apportionment when the receipt is of a mixed character, the reason why an apportionment was not possible needs to be examined.

2.564 It may be asked why the words “ascertainable by calculation” were not satisfied in McLaurin. The High Court referred, apparently without disapproval, to Carter v. Wadman where one of the claims was for a share in profits up to the time of termination of the contract—and thus of a revenue nature—and the other was for surrender of contractual rights of a capital nature. The Court of Appeal held an apportionment was proper. The calculation of the profits no doubt required valuation of the stock in trade of the hotel. And it could only be an estimate since it related to a past year, when the actual profit would be calculated for a full year.

2.565 The High Court judgment in McLaurin (1961) 104 C.L.R. 381 leaves unanswered a number of other questions: Which claims must be liquidated or ascertainable by calculation, those of an income nature or those of a non-income nature or all of them? Is apportionment appropriate where some only of the claims of a non-income nature are liquidated or
ascertainable by calculation or where some only of the claims of a non-income nature are liquidated or ascertainable by calculation? No definitive answer to these questions is afforded by the judgments in Allsop (1965) 113 C.L.R. 341. Carter v. Wadman (1946) 28 T.C. 41 would appear to require that the amount of each claim should be ascertainable by calculation. The total amount received by the taxpayer was distributed between the claims on the basis of the fraction the value of each claim was of the total value of the claims. National Mutual Life Association of Australasia Ltd (1959) 102 C.L.R. 29, decided before McLaurin, might support a requirement that the amount of each claim should be ascertainable. The Commissioner conceded in the case that a total premium paid in respect of a policy of life insurance with additional benefits in the event of disability or death by accident, could be apportioned so as to separate and exempt under s. 111 of the Assessment Act what Windeyer J. described (at 51) as “the true actuarily established premium for the life insurance element”. Other members of the court did not question the Commissioner's concession, and Windeyer J. expressly agreed. If a premium for the life insurance element could be calculated actuarially, so could a premium for the additional element. It would then be possible to apportion the actual premium by the method in Carter v. Wadman. A view that the values of all elements must be capable of ascertainment by calculation is open within the pronouncement by the High Court quoted in [2.563] above, if emphasis is placed on the words “some, at least”.

2.566 Allsop purports to apply McLaurin and can be explained as a decision that apportionment was not possible because the value of the claims for “interference” with the taxpayer's business were not ascertainable by calculation.

2.567 McLaurin and Allsop offer an encouragement to practices in the settlement of claims to compensation which the well-advised may follow in tax planning. They offer the prospect that if there can be shown to be a real claim in respect of a non-income item, the receipt in settlement of this and other claims in respect of items of an income nature may escape tax. The prospect is offered whether the items of an income nature are such by ordinary usage or by some specific provision, for example, s. 72: Allsop.

2.568 In H. R. Sinclair & Son (1966) 114 C.L.R. 537 an assertion was made by the taxpayer that the receipt related to other claims, as well as to the claim for refund of royalties. Owen J. dismissed the assertion, saying (at 546): “The case cannot be treated as though the payment of the refund had been made in settlement of a variety of claims, some relating to the past and some to the future. In no way can it be said to resemble McLaurin's case or Allsop's case.” The case indicates the importance of
finding and making a claim which does not relate to a revenue item, and following the form of settlement used in Allsop.

2.569 If the taxpayer in Allsop had pressed his action to recover the fees as money had and received, and had been successful, the amount recovered would, it seems, have been income as a business gain. Sinclair is the authority, subject, however, to a reservation expressed in [2.551] above. But the form of release by which his claim was in fact resolved, covered not only his claim in respect of the fees he had paid but also “all claims for anything done in purported pursuance of the State Transport (Coordination) Act”. Barwick C.J. and Taylor J. found sufficient in the case stated “to enable it to be said that during the period in question there had been unlawful interferences with the appellant's vehicles and his business operations and in respect of these matters he had valid claims” ((1965) 113 C.L.R. 341 at 351). One would have thought it was necessary to go on to consider whether an amount received in respect of these matters would be income if it stood alone. Such an amount could be characterised as compensation for profits that would have been derived (cf. Gill v. Australian Wheat Board (1981) 81 A.T.C. 4217). Barwick C.J. and Taylor J. concluded that “the amount payable was an entire sum paid by way of compromise of all these claims and no part of it can be attributed solely to a refund of the fees paid . . . ” (at 351). But they cannot have intended to decide that an “entire sum” which relates to several items all of a revenue character, is not income, simply because no part of it can be attributed solely to a particular item.

2.570 The principle in McLaurin and Allsop was most recently applied in National Commercial Banking Corp. of Aust. Ltd (1983) 83 A.T.C. 4715 though there is no reference to those cases in the judgments of the Federal Court. The facts of National Commercial Banking will appear from the discussion in [2.517] above. The trial judge, as his findings were interpreted by the Federal Court (at 4721), had found that it was impossible “to dissect the lump sum [received] and to apportion it among the heads to which it related”. The trial judge had also found that “it was impossible to attribute to portions of the lump sum an income or non-income nature or to determine whether or not they were in the nature of reimbursement of expenses”. It followed that the foundation of the Commissioner's submission that the amount received was income as compensation for the outgoings incurred in building up the Bankcard scheme was destroyed. The reasoning may appear to reverse the onus the taxpayer carries under s. 190 (b) of the Assessment Act. One would have thought that the onus on the taxpayer to show that the assessment was excessive, required him to show that the lump sum included an amount of a non-income nature. The
taxpayer would have had the same difficulties as the Commissioner had, and he would have failed to show the assessment was excessive. The question of onus of proof was equally passed over in the judgments of the High Court in *Allsop*. 

Section 25A and Section 26AAA

3.1 In [2.492]–[2.505] above attention was given to the concept of an isolated business venture as an aspect of the ordinary usage meaning of income, and the question was raised whether that concept, as part of the concept of income for purposes of the Assessment Act, covered a field and should be taken to exclude the operation of s. 25A (formerly s. 26(a) within that field. In [2.171] there is some comment on the scope of the operation of s. 25A.

3.2 In what follows, a closer examination is attempted of the correlation between the concept of isolated business venture and the specific provisions of s. 25A. The opportunity is also taken to explore the correlation between the two limbs of s. 25A(1). The specific provisions of s. 25A are then examined against the background of the judicial interpretations of s. 26(a). Section 25A(1) repeats the provisions of s. 26(a). In its other subsections, s. 25A is directed to overcoming weaknesses which it was considered had been revealed by the judicial interpretation of s. 26(a). These other subsections raise questions of interpretation and structure.

3.3 The Assessment Act has included s. 26AAA since 1973. That section gives an income character to a profit on the sale of property purchased within 12 months of the sale. The correlation between s. 26AAA and the ordinary usage meaning of income as the latter has been received into the meaning of income for purposes of the Assessment Act, and the correlation between that section and s. 25A(1) are to some extent determined by the operation of provisions of s. 26AAA itself. But questions remain.

The Correlation between the Received Ordinary Usage Concept of an Isolated Business Venture and the Provisions of Section 25A

3.4 Until the decision of the High Court in Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355 there remained doubt as to whether the ordinary usage meaning of income that relates to an isolated business venture—in the United Kingdom, “an adventure in the nature of trade”—was part of our law. It was possible prior to Whitfords Beach to argue that profit from an isolated business venture was not income for purposes of the Assessment
Act, either because that part of the ordinary usage meaning of income had never been received by the Assessment Act, or that it had been excluded by s. 26(a) (the predecessor of s. 25A(1)), which provided a code in relation to isolated ventures. A correlation between the ordinary usage meaning and s. 26(a) of the kind proposed by Barwick C.J. in Investment & Merchant Finance (1971) 125 C.L.R. 249 would follow, so that ordinary usage supplied the meaning of income in relation to a continuing business while s. 26(a) exclusively supplied the meaning of income in relation to an isolated venture. Barwick C.J. said (at 255):

“In the first place it is an error in my opinion to think that the transactions of a business can be taken item by item and each treated as falling within s. 26(a). The business must be regarded as a whole, its receipts being assessable income from which the permitted deductions are to be deducted. Section 26(a) is intended in my opinion to deal with transactions which are entire in themselves and do not form part of a more extensive business. In that event they are regarded as yielding a profit which will be calculated according to the circumstances of the transaction, the profit only being assessable income.”

On this analysis the limitations on the operation of s. 26(a), established by judicial decision, had maximum significance. Those limitations, in relation to the first limb, included the requirement of purposive acquisition, the requirement of sale and the requirement of identity of the property acquired and the property sold. The first limb of s. 26(a) provided that “the assessable income of a taxpayer shall include profit arising from the sale by the taxpayer of any property acquired for the purpose of profit-making by sale”. Section 25A(1) repeats that provision. Limitations on the operation of the second limb were less firmly established, but Barwick C.J. had proposed a requirement that “there must be an identifiable specific scheme existing at the date of the acquisition of the property which is to be used to execute the scheme to make a profit” (Steinberg (1975) 134 C.L.R. 640 at 688). And he had proposed for a time a view that the second limb could not apply unless there had been an acquisition of property by way of purchase. The second limb of s. 26(a) provided that “the assessable income of a taxpayer shall include profit arising from . . . the carrying on or carrying out of any profit-making undertaking or scheme”. Section 25A(1) repeats that provision.

3.5 The above analysis is one that was convenient in the respect that s. 26(a) was kept out of the field of continuing business where its operation—at least in regard to the first limb—would have been involved in irreconcilable conflict with the trading stock provisions of the Assessment Act.

3.6 Whitfords Beach is a landmark decision in holding that the part of the
ordinary usage meaning of income concerned with the notion of profit from an isolated business venture is some of the meaning of income for purposes of the Assessment Act. Gibbs C.J. and Mason J. decided the case by the application of that notion. Wilson J. was content to rely on the second limb of s. 26(a) without rejecting the possible operation of the ordinary usage notion. Wilson J. did not have to consider the consequences of a conflict between the ordinary usage notion and s. 26(a), because none arose in relation to the facts of the case. For the same reason Gibbs C.J. and Mason J. did not need to consider possible conflict in other circumstances, and they sought to lay the basis in doctrine for avoiding conflict by asserting that s. 26(a) had no application where the notion of isolated business venture will bring in a profit as income for purposes of the Assessment Act. Gibbs C.J. said (at 366):

“However, the fact that the profits yielded by some transactions which fall within the literal meaning of the words of s. 26(a) will not be brought to tax under that provision, since the transactions form part of a more extensive business, supports the view that s. 26(a) does not apply where s. 25(1) is applicable. Moreover, any business conducted for profit can be described as a profit-making undertaking or scheme, but it is impossible to suppose that the Parliament intended (contrary to settled practice) that the profits of every business should be dealt with under s. 26(a) rather than under the general provisions of s. 25. Not without some doubt I have therefore reached the conclusion that although the provisions of s. 26(a), if given full effect, would overlap those of s. 25, the second limb of s. 26(a) applies only to ‘profits not attributable to gross income that has already been captured by s. 25’, to use the words of Mason J. in . . . Bidencope (1978) 140 C.L.R. at 555. It is implicit in what I have said that I consider that the second limb of s. 26(a) includes profits which would not otherwise have fallen within s. 25, because they could not be described as income in the ordinary sense. I have discussed that question in . . . Bidencope (1978) 140 C.L.R. at 551–552, and adhere to what I there said in relation to this aspect of the matter.”

Mason J. said (at 382–383):

“One view is that s. 26(a) should be applied to the cases which fall within its terms, to the exclusion of s. 25(1)—see Reseck . . . (1975) 133 C.L.R. 45 at 49, 57. After all, s. 26(a) is a specific provision introduced for the purpose of catching profits yielded by the transactions which it describes. Moreover, it has generally been applied to cases falling within its terms without the court examining in detail whether s. 25(1) might also have had an application (Steinberg (1975) 134 C.L.R. at 710; Bidencope (1978) 140 C.L.R. at 552; . . . St Hubert's Island Pty Ltd (in liq.) (1978) 138 C.L.R. 210 at 229–230; Pascoe (1956) 30 A.L.J. 402.

The second view is that s. 26(a) will only operate when s. 25(1) does not do so (Investment and Merchant Finance (1971) 125 C.L.R. at 255, 264; Steinberg (1975) 134 C.L.R. at 688). This is the view which I have been disposed to favour in the past
(see *St Hubert's Island* (1978) 138 C.L.R. at 229–230; *Bidencope* (1978) 140 C.L.R. at 555). Its rationale is that s. 26(a) should be considered as supplementary to s. 25 (1) which continues to operate as the principal statutory provision on the revenue side. As I have already indicated, it was no part of the purpose of s. 26(a) to limit the operation of s. 25(1). Indeed, in large measure its object was to ensure that the revenue did not suffer in the event that s. 25(1) received a more restricted application than it was then thought to have. I am still inclined to think that this is the preferable view and that, accordingly, the second limb of s. 26(a) applies only to ‘profits not attributable to gross income that has already been captured by s. 25’ (*Bidencope* (1978) 140 C.L.R. at 555).”

3.7 The idea of “conflict” between the notion of profit from an isolated business venture and the notion of profit under s. 26(a), calls for some comment. It is arguable that there is no conflict when both would bring in a profit of the same amount. In any case the conflict is without significance. There may be conflict when one would bring in a profit and the other would not, or when both would bring in a profit but the profits are of differing amounts because of differences in the principles applicable in their calculations.

3.8 The conflict might be resolved in the latter circumstances by adopting a principle that the Commissioner is entitled to tax the higher amount. The principle has little to commend it, save that it would favour the Commissioner. The same principle might be adopted to allow the Commissioner to tax where one notion would not give rise to any tax and the other would. But in both cases a rational resolution of conflict should adopt the approach of Gibbs C.J. and Mason J. in *Whitfords Beach*, so that each notion is allotted a distinct field of operation. The allocation of fields suggested by those judges is that the isolated business venture notion occupied the field to the exclusion of s. 26(a) whenever the notion operated to bring in an amount that was income, or a loss that was deductible. If it did not bring in a profit that was income or a loss that was deductible, the circumstances might have given rise to a profit that was income or a loss that was deductible under s. 26(a) or s. 52. Such a resolution would have disappointed the Commissioner if s. 26(a) and s. 52 would have yielded a higher profit or a lesser loss, and would have disappointed the taxpayer if s. 26(a) and s. 52 would have yielded a lesser profit or a higher loss.

3.9 The allocation of fields by preferring the notion of an isolated business venture whenever that notion would give rise to a profit or loss is not of course the only possible allocation. A field for an isolated business venture could be drawn in a way that would have excluded s. 26(a) even though the application of the notion did not give rise to profit that was income or loss that was deductible. The defining of the field would pose problems of
analysis and of policy. An argument could be made that the notion of an isolated business venture covers the field though a transaction is aborted by the making of a gift of the property concerned.

3.10 The need to resolve what is now the problem of the correlation between the operation of the ordinary usage notion of profit from an isolated business venture and the operation of s. 25A(1) has become the more acute. The adding of provisions to s. 25A will tend to expand its operation, within whatever field is allocated to it, and the adding of provisions to s. 52 will limit the losses that s. 52 can allow.

3.11 Section 26(a) began its history as a reaction to the United Kingdom decision in Jones v. Leeming [1930] A.C. 415 which was thought to be a decision that a simple acquisition of property for the purpose of profit-making by sale and a sale of that property is not an isolated business venture. The suggestions are made by Mason J. in Whitfords Beach that Jones v. Leeming is not such a decision, and even if it is, it has been overruled by later decisions. The prospect is thus open that a transaction described by the words of the first limb of s. 25A(1) is an isolated business venture, so that a profit arising from it will be determined by the principles that make up that notion. If the view of Gibbs C.J. and Mason J. in Whitfords Beach as to the correlation of isolated business venture and s. 26(a) now represents the law and applies to the correlation of that notion and s. 25A(1), the elaborate new provisions in s. 25A and s. 52 will have little if any room in which to operate.

The Correlation between the Two Limbs of Section 25A(1)

3.12 Whatever view is taken of the correlation between the notion of a profit from an isolated business venture and the notion of a profit under s. 25A(1), there will remain a problem of correlating the operations the two limbs of s. 25A(1). The resolution of that problem may leave even less room for the operation of the first limb of s. 25A(1).

3.13 The repeal of s. 26(a) is expressed to take effect in relation to sales of property after 23 August 1983, except in so far as s. 26(a) relates to the carrying on or carrying out of any profit-making undertaking or scheme. And the operation of s. 25A commences in relation to sales of property after 23 August 1983, except in so far as the section relates to the carrying on or carrying out of any profit-making undertaking or scheme. An inference might be drawn that the two limbs of s. 25A(1), are mutually exclusive. It might be inferred that where property is acquired for the purpose of profit-making by sale in a profit-making undertaking or scheme, the first limb can have no operation. If this is a correct inference, and the
view of Gibbs C.J. and Mason J. in *Whitfords Beach* as to the correlation of the ordinary usage notion of isolated business venture and of s. s. 25A is adopted, the first limb of s. 25A(1) will be crowded out by the ordinary usage notion and by the second limb.

3.14 There is of course a question of defining the field of the second limb so that it is beyond the field of the ordinary usage notion. At one time, after *McClelland (1970)* 120 C.L.R. 487 it seemed that the provision had no field of its own. More recent authority, including *Whitfords Beach*, suggests that it had: something less in the system and organisation that it reflects may make a transaction a scheme within the second limb, though there is not sufficient system and organisation to make it an isolated business venture. Thus the protection of the doctrine of advantageous realisation explained in [3.68]ff. above, may be the more difficult to secure where the second limb is applicable than where the notion of isolated business venture would be applicable. The field of the second limb remains a matter of conjecture, but, if it can be identified, it seems that it will preclude the operation of the first limb.

3.15 If the presence of an isolated business venture or of a transaction within the second limb will exclude the operation of the first limb, either will, it seems, exclude the operation of all the new subsections of s. 25A, and all the new subsections of s. 52 with the exception of s. 52(5) (a). All the new subsections of s. 25A are indissolubly linked with the first limb of s. 25(A1) by the use of the phrase “acquired . . . for the purpose of profit-making by sale”, and, in most instances, by a reference to sales after 23 August 1983 which is the commencing date for the first limb of s. 25A(1). All the new subsections of s. 52, other than subs. (5) (a), are indissolubly linked with the first limb of s. 25A(1) by the use of the phrase “acquired for the purpose of profit-making by sale”. Section 52(5) (a) is linked in some measure with the first limb: significance is given by s. 25A to a sale in the “prescribed manner” only in the context of property having been acquired for profit-making by sale. But it may have a wider operation to deny a loss where the sale is made in carrying out a profit-making undertaking or scheme.

**Background: The Interpretation of Section 26(a)**

The first limb of section 26(a)

3.16 The first limb of s. 26(a) probably gave rise to more litigation than any other provision of the Assessment Act, though most often the issue was one of fact. Some of the interpretations of the provision imported fine
legal analyses of a kind that is more appropriate in property law, some jurisprudential analysis of fundamental concepts such as intention, purpose and motive, and subtle refinements on onus of proof that might delight the student of the law of evidence.

**The requirement that the property sold must be the property acquired**

3.17 A requirement of identity of the property acquired with the property sold became evident in *White* (1968) 120 C.L.R. 191. Windeyer J. rejected any possible application of the first limb on the ground that land acquired with growing timber on it is not sold when the timber is sold. The requirement of identity was asserted by Windeyer J. and Barwick C.J. in *McClelland* (1969) 118 C.L.R. 353 so as to justify rejecting the application of the first limb in a case where a half interest as tenant in common in land is acquired by a person who already has the other half interest, and the merged interests are sold. The requirement was assumed by the Privy Council in the same case: (1970) 120 C.L.R. 487. It was the basis of the decision in *Miranda* (1976) 76 A.T.C. 4180 that rights to new shares, attendant upon an existing holding of shares, were not property acquired when the existing shares were acquired. The requirement was accepted by Barwick C.J. and McTiernan J. in *A. L. Hamblin Equipment Pty Ltd* (1974) 131 C.L.R. 570: there was no relevant identity where rights under a hire-purchase agreement were exercised and rights as owner were sold, or where the lessee acquired the reversion under a lease and sold his rights as owner. Barwick C.J. in *Steinberg* (1975) 134 C.L.R. 640 appeared to think there was no identity if shares in a company were acquired and land received in the liquidation of the company was sold, though his decision may depend on another aspect of his interpretation of the first limb of s. 26 (a) which would require that the acquisition of property sold must have been by purchase.

3.18 The precise limits of the requirement of identity remained undetermined in some respects. Mason J. in *Hamblin* considered that there was identity if property was acquired, and newly created strata titles to parts of it were sold. There was no decision on how the acquisition of property and the sale of undivided interests in the property should be regarded.

**Purpose of profit-making by sale**

3.19 There must have been an acquisition of property “for the purpose of profit-making by sale”. All authorities indicated that it was the purpose in fact of the taxpayer—the subjective purpose—that was relevant. The
purpose in the first limb of s. 26(a) thus differed from the purpose to be predicated by looking at the overt acts of the taxpayer, a purpose that was relevant to the operation of s. 260 ([16.24]ff. below), and relevant to a conclusion that there is a continuing business ([2.444]ff. above).

3.20 There was a distinction to be drawn, within the concept of purpose, between immediate purpose, which refers to the means to some end, and ultimate purpose, which refers to the end which the means will serve. Immediate purpose is sometimes referred to as intention, and ultimate purpose is referred to as motive. Subject to a possible inference to be drawn from McClelland, to which reference is made in [3.23] below, and to the implication of a view taken by Jacobs J. in Macmine referred to in [3.25] below, the first limb of s. 26(a) was concerned with immediate purpose.

3.21 In most circumstances immediate purpose and ultimate purpose, as they were relevant to the operation of s. 26(a), are the same—the taxpayer buys to sell at a profit and the profit is both the immediate and the ultimate purpose. And the taxpayer does not have any competing purpose. If he does have a competing purpose, for example to hold for enjoyment or investment, the first limb of s. 26(a) required that his dominant purpose be determined: was his purpose to sell profitably the principal determinant of his actions?

3.22 Analysis became more complex where the taxpayer acquired property with a purpose, as to part of the property, to sell profitably, and a distinct purpose, as to another part, to hold for enjoyment or investment. If the part of the property to which the purpose to sell profitably related was fixed at the time of the acquisition, no special difficulty would arise. If it was not fixed, analysis would remain simple if the subsequent fixing was taken to identify the property about which he had the purpose to sell profitably, though there was some conflict with a view that the purpose which brought s. 26(a) first limb into operation had to subsist at the time of acquisition of the property. If the subsequent fixing did not operate in this way, the analysis had to proceed on a dominant purpose as to the whole of the property approach, or on an approach which would characterise the purpose to hold for enjoyment or investment as the ultimate purpose as to the whole, and may assert that this is the relevant purpose. The former approach would tend to concentrate on the value of the part of the property sold, compared with the value of the part held, and on whether the taxpayer was at all times compelled to acquire the whole of the property if he was to acquire any of it. The latter approach would tend to concentrate on this factor of compulsion, and on the relationship between the purpose of selling profitably and the purpose of holding: was it commercially
necessary or advisable for the taxpayer to sell what was sold in order to finance the acquisition of what was retained? The purpose of selling a part profitably might thus be made to appear the immediate but irrelevant purpose, and the purpose of holding the ultimate and relevant purpose, of the whole transaction.


3.24 If ultimate purpose had in all circumstances been the relevant purpose under the first limb of s. 26(a), some unacceptable consequences would have followed. A taxpayer who saw an opportunity to profit by acquiring and selling property next door to his own, might have been able to establish that he was predominantly moved in acquiring the property by the opportunity to be rid of an undesirable neighbour, or by an opportunity to build on the property next door in a way that would ensure that his own desirable view would never be obstructed.

3.25 In Macmine Pty Ltd (1979) 53 A.L.J.R. 362 at 376, Jacobs J. took the view that the acquisition and sale of the Minsec shares acquired in exercise of options which had not been acquired with any profit-making purpose, were simply steps in the advantageous realisation of those options. The advantageous realisation doctrine, imported from isolated business venture learning, is considered below in [3.68]ff. It is curious that the ultimate purpose which, it has been submitted, was not the relevant purpose under the first limb should become relevant because the acquisition and sale were “steps” in a scheme, more especially when the scheme escaped the second limb. The view of Jacobs J. may amount to a rejection of the view that purpose in relation to the first limb referred to immediate purpose. Alternatively it is the assertion of a view that an acquisition with the subjective purpose of profit-making by sale was not within the first limb if it was a part of a scheme that was within the field of the second limb. Either view casts some doubt on Executor Trustee & Agency Co. of S.A. Ltd (Bristowe’s case) (1962) 36 A.L.J.R. 271. Where a rights issue was
made in relation to shares which were not acquired for resale at a profit, Bristowe's case was authority that the first limb might be applicable to shares acquired in exercise of those rights, the profit which is income being calculated in a way that allowed the value of the rights as a cost. But the acquisition of the shares in exercise of the rights in Bristowe's case might have appeared to be an advantageous realisation of the rights in the same way as the acquisition of the Minsec shares in Macmine was regarded by Jacobs J. as a step in the advantageous realisation of the options. The view taken by Jacobs J. raised a question of the correlation between the first and second limbs—a matter considered in [3.12]–[3.15] above. Where the circumstances amounted to a scheme within the second limb, there was good reason to treat the first limb as excluded. It is at least unsatisfactory analytically to treat an acquisition and sale which was an aspect of a scheme as a transaction within the first limb. There were problems, however, in defining the field of the second limb—the field from which the operation of the first limb is excluded. The view of Jacobs J. would delineate the field in a way that would have included circumstances where a scheme did not give rise to a profit that was income. The consequences favour the taxpayer. The prospect was raised that a transaction, otherwise within the first limb, would escape tax because it was within the field of the second limb, and the circumstances within the field of the second limb escaped tax because they did not give rise to a profit that was income. The view of Jacobs J. in Macmine was adopted and applied by Tadgell J. in Leibler (1982) 82 A.T.C. 4005.

3.26 There are questions as to what was meant by purpose “of profit-making by sale”. A purpose to retain property “in the hope or expectation that its value will increase” is not such a purpose, and a purpose to “hedge against the loss of value in the currency” is not such a purpose: Steinberg (1975) 134 C.L.R. 640 at 686 per Barwick C.J. The first observation would have the support of the Privy Council judgment in McClelland. The second observation is a recognition of the falseness of an assumption otherwise made in the Assessment Act that a dollar is of unchanging value. That assumption would require that a purpose to hedge be treated as a purpose of profit-making by sale, unless sale is not contemplated by the taxpayer.

3.27 The purpose of profit-making by sale had to subsist at the time of acquisition of the property. A change of purpose thereafter would not abort the operation of the first limb: Moruben Gardens Pty Ltd (1972) 46 A.L.J.R. 559. There are questions as to what was the relevant moment of acquisition. Where the acquisition is completed by the exercise of an option, the moment of acquisition was the exercise of the option: Macmine Pty Ltd (1979) 53 A.L.J.R. 362 per Gibbs J. At least this was so where the
option did not relate to a specific item of property. Where it did, there were, it seems, two acquisitions—one at the time the option was acquired, and the other on the exercise of the option: *A. L. Hamblin Equipment Pty Ltd* (1974) 131 C.L.R. 570. If the purpose subsisted only at the time of the second acquisition, problems of identity, considered in [3.17]–[3.18] above, might have precluded the operation of the first limb.

**Purpose in relation to income derived through an intermediary or an agent**

3.28 A company is a taxpayer, and it is the company's purpose that controlled the operation of the first limb of s. 26(a). Sometimes it may be difficult to identify the person or persons whose subjective purpose will be attributed to the company. In *Coburg* (1960) 104 C.L.R. 650 and *Point Cook Pastoral Co. Pty Ltd* (1979) 79 A.T.C. 4419 it was not difficult to identify the relevant person. There was more difficulty in *Macmine Pty Ltd* (1979) 53 A.L.J.R. 362. Where there has been collegiate action, for example by the board, it may be necessary that a majority have the relevant purpose.

3.29 Where “net income” of a partnership for purposes of s. 90 of the Assessment Act was to be determined, it seems that a separate calculation of “net income” had to be made in relation to each partner where there was any partner who did not have the purpose of profit-making by sale: *Pascoe* (1956) 30 A.L.J. 402. Where the “net income” of a trust for purposes of s. 95 of the Assessment Act had to be determined and there were several trustees, presumably the majority of trustees must have had the purpose of profit-making by sale. There can be only one calculation of “net income”.

3.30 The principle referred to in [3.27] that a change of purpose after acquisition would not abort the operation of the first limb of s. 26(a) would apply to a change of purpose of a company which may, for example, follow a change in control: *Moruben Gardens*. It may be asked whether a partner entering a partnership after the acquisition of property by the partnership was subject to the operation of the first limb of s. 26(a), because of the purpose of those who were partners at the time of acquisition of the property by the partnership. *Tikva Investments Pty Ltd* (1972) 128 C.L.R. 158 may suggest that he was. *Pascoe* would, however, suggest that he was not. There is, it should be noted, no deemed disposal by the original partners, and acquisition by them and by the new partners. Section 36 and s. 36A, considered in [14.59]ff. below, had no application in relation to s. 26(a).

3.31 It may be asked whether a change of trustee, or the addition of a new trustee, would have aborted the operation of the first limb of s. 26(a). There
was, one would think, no room for reasoning that might be drawn from *Pascoe*, despite the similarities of the language of s. 90 and the language of s. 95. On the other hand, there was no compelling reason for preferring the analogy with a change in control of a company.

3.32 The calculation of “net income” under s. 95 is made “as if the trustee were a taxpayer”. Following the analogy with a change in control of a company would require an interpretation of those words which would abstract the concept of trustee from the persons who are for the time being trustees, and this may not accord with the general law of trusts. None the less the abstraction might be justified by the reference to “trust estate” in s. 95, which expresses such an abstraction. The reference is not to the trust property but to the trust entity. The difficulty of reconciling the abstraction with the relevance of the subjective purpose of the actual trustee at the time of acquisition of the property, is no greater than the difficulty in the similar context of a company and its directors. The agent's purpose is attributed to his principal.

**Purposive acquisition**

3.33 *McClelland* (1970) 120 C.L.R. 487 and *N. F. Williams* (1972) 127 C.L.R. 226 are authority that the purpose of profit-making by sale must have actuated the acquisition of the property. In the case of a receipt under a gift, this would require, at the least, that the gift must have been solicited by the taxpayer. Barwick C.J. indeed held the view that an acquisition under a gift could never attract the operation of the first limb of s. 26(a): there had to be an acquisition by purchase (*N. F. Williams* and *Steinberg* (1975) 134 C.L.R. 640). His view depended primarily on the need for a cost upon which the profit could be determined, and on an assumption that a receipt under a gift does not have a cost. The view of Barwick C.J. was not generally accepted. It was not taken by Kitto J. in *McClelland* in the High Court ((1969) 118 C.L.R. 353) nor by Lord Pearson in the Privy Council in that case. It was not accepted by the other judges in *N. F. Williams*.

3.34 The need for purposive acquisition became a basis of tax planning which relied on it to immunise a spouse from a s. 26(a) first limb liability where property was received by way of gift from the other spouse. The other basis of the planning—that a gift is not a sale by the donor spouse—is referred to in [3.36] below.

3.35 The requirement that there had to be a purposive acquisition would generally have excluded shares received in a bonus issue, or rights or options issued by a company, from the operation of the first limb of s. 26
(a). *Miranda* (1976) 76 A.T.C. 4180 is authority that these bonus shares, rights or options were not acquired when the shares in relation to which the issues were made were acquired by the taxpayer shareholder. And it would appear from *Macmine Pty Ltd* (1979) 53 A.L.J.R. 362 that there was no purposive acquisition at the time of issue of the bonus shares, options or rights, save, perhaps, where the taxpayer controlled the company making the issue, and participated in the decision to make the issue.

**Sale by the taxpayer**

3.36 If property was given away there was no sale and the first limb of s. 26(a) had no operation. In any case a gift would not have generated a profit unless there were some provision, such as s. 36, which would have deemed the gift to be a sale at market value.

3.37 “Sale” was held to extend to a compulsory sale following resumption of property: *Coburg Investment Co. Ltd* (1960) 104 C.L.R. 650 and *Steinberg*. In *Coburg* Windeyer J. held that there had been a sale, notwithstanding that the disposition by the taxpayer was as a result of a notice to treat issued by a public authority. He referred to the fact that the price had been fixed by negotiation, at the same time expressing the view that compulsion or pressure did not prevent a disposition being a sale under s. 26(a). There remained a question whether there was a sale under a different resumption procedure.

3.38 The sale had to be “by the taxpayer” who acquired the property with the purpose of profit-making by sale. A sale by the estate of a deceased person would not, it seems, satisfy the first limb of s. 26(a), though there was an argument that s. 101A (considered in [11.150]ff.) would supplement the words of s. 26(a) so that the profit was income of the estate. A sale by the official receiver of a bankrupt would not satisfy the first limb: *Official Receiver in Bankruptcy (Fox's case)* (1956) 96 C.L.R. 370. But, it seems, a sale by the liquidator of a company would satisfy: *St Hubert's Island Pty Ltd* (1978) 138 C.L.R. 210.

**The calculation of profit**

3.39 It was noted above that, in relation to the first limb, Barwick C.J. took the view that the acquisition had to be by way of purchase—presumably purchase in circumstances where the price set does not reflect any element of gift. The view taken by other members of the High Court was that, provided the acquisition was purposive, an acquisition by receipt of a gift might bring s. 26(a) into operation. In these circumstances, the cost would be the market value of the property at the time of acquisition. United

3.40 In *Becker*, Kitto J. said (at 467) that business conceptions determined what was a profit for purposes of s. 26(a). One must deduct, he said, “the amount or value of all that it in fact has cost the recipient to obtain [the] ultimate sum”. The determination of cost in a case where there had not been a purchase of the property for cash, for example where the property had been acquired by way of exchange, posed problems of valuation. And there were problems in characterising the transaction. In *Becker* a finding that Becker had sold to the company for cash and thereupon subscribed for shares would have involved the result for which the Commissioner contended. Where the property had been purchased, there was a question whether the purchase price was definitive as to the cost of the property for purposes of calculating the profit. So far as s. 51 is concerned, *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430 would appear to suggest a principle which virtually precludes the Commissioner from going behind the purchase price where it exceeds market value. It may be asked whether the principle in *Cecil* extended to the determination of “cost” for purposes of calculation of a profit under s. 26(a). Section 65 was not available to the Commissioner: it is not concerned with the subtraction of cost in computing a profit.

3.41 Property may have been acquired at less than its market value, perhaps by a member of a family from another member who did not wish to realise a profit. There is a question whether it was open to the purchaser to argue that his cost was greater than the price he paid, contending that the element of donation must be included. The cases referred to in [3.39] supported the purchaser's argument.

3.42 While the determination of profit for purposes of s. 26(a) involved recourse to accounting conventions, it was ultimately for the court to say what conventions were appropriate.

3.43 Tax accounting for a profit from the sale of property where there is no continuing business is concerned with actual or constructive receipts: *Thorogood* (1927) 40 C.L.R. 454. There is a derivation of a profit only when and to the extent that the profit is found in an actual receipt or constructive receipt. There may be a constructive receipt (by the ordinary usage meaning of derivation or under s. 19) if the transaction involves a
loan by the taxpayer to the buyer of the amount of the purchase price. If there is a constructive receipt, the whole profit will fall to be included in income on the making of the sale.

3.44 If the contract is rescinded for the default of the buyer and under the contract instalments already received are retained by the seller, the profit arising will include the whole of the instalments received: *L'Estrange* (1978) 78 A.T.C. 4744.

**The effect of interposition of a company**

3.45 *George W. Cheverton Pty Ltd* (1962) 12 A.T.D. 461 demonstrated that the application of the first limb of s. 26(a) might be attracted, though the original acquisition of property by a taxpayer was not for the purpose of profit-making by sale, if he vested the property in a company which thereafter disposed of it. In *Cheverton*, Crawford J. was able, on the facts, to escape an inference that the company had acquired for purpose of profit-making by sale. But in other situations the first limb of s. 26(a) would have made the profit derived by the company income. Of course the company must have made a profit: this depended on the price at which the property had been sold to the company and whether that price was definitive in determining the company's cost for purposes of calculating any profit it had made. *Bidencope* (1978) 140 C.L.R. 533 affords another illustration of how the interposition of a company could generate income under s. 26(a). The property sold to the company might have been sold to a third party without generating any tax liability. The acquisition and sale by the company raised the prospect that income had been generated.

3.46 In *Hobart Bridge Co. Ltd* (1951) 82 C.L.R. 372 the sale by the holding company of its shares in its subsidiary did not give rise to an operation of s. 26(a). These shares had not been acquired for resale at a profit though the subsidiary held property acquired by it for profit-making by sale. Section 26(a) did not apply to bring in any amount as income of the holding company on the sale of those shares. *Hobart Bridge* suggested tax planning whereby a taxpayer mad use of a “shelf” company in which he was a shareholder to acquire property which the taxpayer believed would substantially increase in value, the intention being that the taxpayer would at an appropriate time sell the shares rather than have the company sell the property. The “shelf” company might be one that had been formed for some other purpose, and which for a time had engaged in activities related to that purpose. In these circumstances there would have been no evidence from which an inference could be drawn that the original acquisition of the shares was for the purpose of profit-making by sale. It
might however have been open to the Commissioner to argue that what was done amounted to a profit-making scheme within the second limb of s. 26(a). In *Hobart Bridge* the circumstances did not show any scheme to generate an increase in the value of the assets of the subsidiary in order that the shares held by the taxpayer might ultimately be sold at a profit. But on other facts there could have been an argument that such a scheme was involved. There would be a question as to how far the acts of a company were acts in the carrying out of a scheme by a shareholder. In *McRae* (1969) 121 C.L.R. 266, the company's acts were so regarded. But some of the judgments in *Macmine Pty Ltd* (1979) 53 A.L.J.R. 362, more especially that of Jacobs J. in relation to the Petsec shares, suggest that the company's acts could not always be so regarded.

The element of “business deal”

3.47 The judgment of the majority of the Privy Council in *McClelland* (1970) 120 C.L.R. 487 brought a good deal of confusion into the interpretation of the first limb of s. 26(a). The majority judgment might be taken to have rejected the application of the first limb because of the failure to satisfy the identity principle in relation to the half interest the taxpayer acquired from her brother, and because of the failure to satisfy the purposive acquisition principle in relation to the taxpayer's own half interest. There was, however, an inference to be drawn from the majority judgment that the requirement of “business deal”, said to be implicit in the second limb of s. 26(a), was also a requirement of the first limb.

3.48 In the majority judgment a business deal requirement was implied into the second limb by a process of reasoning which first asserted that the second limb was simply a statement of part of the ordinary usage meaning of income. It was a statement, perhaps a limited statement, of that part of the ordinary usage meaning which in the United Kingdom is expressed in the notion of an adventure in the nature of trade and which was considered in [2.495]ff. above. The phrase “business deal” identified the central element in the notion of adventure in the nature of trade.

3.49 The importing of the requirement of a business deal into the first limb of s. 26(a) would, as pointed out by Lord Pearson in his dissenting opinion in *McClelland*, have restored *Jones v. Leeming* [1930] A.C. 415 as part of the law in Australia despite the attempt in 1930, by the enactment of the predecessor of s. 26(a), to reject it.

3.50 In a number of cases, in the period immediately after *McClelland*, the High Court referred to the possibility that the business deal notion might be an aspect of the first limb. In *A. L. Hamblin Equipment Pty Ltd* (1974) 131
C.L.R. 570 at 576 Barwick C.J. asserted that the Privy Council in McClelland had concluded that “as to both limbs of s. 26(a) the transaction . . . must exhibit features which give it the character of a business deal” and expressed the view that the Privy Council's conclusion was binding on the High Court. It followed, he thought, from the business deal notion that “the taxpayer in acquiring the property [must have] the purpose of trading in it or with it”.

3.51 No other member of the High Court expressed the same view. And later statements by Barwick C.J. created perplexity by asserting at once that the “business deal” notion was an element of both limbs of s. 26(a) and that s. 26(a) was intended to bring in gains which would otherwise be capital gains—by which the Chief Justice must have meant gains that would not be income by virtue of the ordinary usage meaning of income. In Bidencope (1978) 140 C.L.R. 533 at 540 he said:

“I have regarded s. 26(a) as a whole as an endeavour to bring into assessment gains which were not in themselves income according to ordinary concepts or according to any other statutory provision. The aim seems to be to treat a capital gain in a single transaction as assessable income because of the trading nature of the transaction which has produced it.”

3.52 Both assertions by Barwick C.J. cannot have been true, unless “business deal” as imported into s. 26(a) had a different meaning from the meaning it has in any statement of the United Kingdom law on adventure in the nature of trade, or, alternatively, United Kingdom law on adventure in the nature of trade is not an aspect of the ordinary usage meaning of income. It is hard to imagine what the notion of business dealing, or of commercial dealing as it was sometimes called by Barwick C.J., may mean if it is to be distinguished from that notion in a statement of adventure in the nature of trade principles. And the reaction of the legislature in 1930 to the decision in Jones v. Leeming can only be explained by an assumption, at that time, that adventure in the nature of trade principles were part of our law as principles of ordinary usage income.

3.53 The continuing significance of the judgment of the Privy Council in McClelland (1970) 120 C.L.R. 487 in relation to the first limb of s. 26(a) was not a matter about which any firm conclusion could be drawn. One suspects that the possibility that a “business dealing” or “commercial dealing” element had been imported would in time have ceased to be considered by the High Court, and the first limb would again have been seen as extending the Australian law beyond the adventure in the nature of trade principles. A denial that “business deal” was an aspect of the first limb may be thought to have been the desirable outcome. The “business
deal” element in the United Kingdom law may be thought to be unnecessarily restrictive.

**Deduction of loss**

**3.54** Section 52, in its terms while s. 26(a) existed, as now, provided that a loss incurred by a taxpayer upon the sale of any property or from the carrying on or carrying out of any undertaking or scheme, the profit (if any) from which sale, undertaking or scheme would have been included in his assessable income, is an allowable deduction. There is, however, a proviso which makes the deduction allowable only in the discretion of the Commissioner if the taxpayer has not given the notice specified in s. 52 that the relevant property was acquired for the purpose of profit-making by sale. Section 52 is linked by its language with s. 26(a) and now with s. 25A(1), and has no application to a loss that arises in circumstances where a profit would have been income only under s. 26AAA: Werchon (1982) 82 A.T.C. 4332.

**3.55** The deduction for a loss is available only when the property has been sold. The anticipation of a loss by writing down the value of an item of trading stock to its market value, which is possible under the trading stock provisions, is not possible in relation to property to which s. 26(a) applied or to which s. 25A(1) applies.

**3.56** There was no provision in s. 52 while s. 26(a) existed which would deny a loss deduction, in circumstances in which s. 26(a) was applicable, if the sale was not an arm's length sale of the property and it was for an amount less than the market value of the property. The circumstances of the sale might have supported a conclusion that the property was not acquired for the purpose of profit-making by sale. But if the subjective purpose of profit-making by sale was established, a sale at less than the value of the property might, it seems, have limited the profit that was income or given rise to a loss. A new subs. (5)(a) added to s. 52 in 1984 has made a significant change in s. 52 in this respect. The new subsection is referred to in [3.109] below.

**The second limb of section 26(a)**

**The identity principle**

**3.57** In its terms, the second limb did not depend on the property sold being identified with property acquired with a relevant purpose, as did the first limb. The identity principle, which assumed so much importance in relation to the first limb, might therefore appear to have had no application.
However, Barwick C.J. insisted on contemporaneity of commencement of the scheme and of the acquisition of property to which the scheme related: *Steinberg* (1975) 134 C.L.R. 640 at 688 (quoted in [3.69] below). A principle of this kind may have had as its corollary a principle corresponding with the identity principle in relation to the first limb.

3.58 *Miranda* (1976) 76 A.T.C. 4180 considered in [3.17] above as a decision on the first limb, was accepted by the Commissioner in *Macmine* (1979) 53 A.L.J.R. 362 and expressly endorsed by Sheppard J., at first instance, and Gibbs J. in the High Court in that case. It was, however, possible that the profit—presumably the proceeds of sale of the rights less the costs of sale—on the realisation of the rights would have been income under the second limb. The relevant scheme would have involved the acquisition of the shares with the purpose of acquiring the rights and selling the rights. Such a scheme was found by Gibbs, Stephen and Murphy JJ. in *Macmine* in relation to the Petsec rights. Jacobs and Aickin JJ. thought there was no such scheme. If the threat of a second limb scheme was discounted, *Miranda* appeared to offer scope for tax planning that would have been proof against the operation of s. 26(a). Rights might have been issued exercisable at less than the market value of the shares in relation to which they were issued and the shares thereafter realised at a loss. Section 52A may have been available to the Commissioner to defeat such planning. And there was some prospect of the application of the first limb if the taxpayer had participated as a controlling shareholder in the decision to make the rights issue. The latter possibility is mentioned in [3.35] above.

**Profit-making and business deal**

3.59 There was no express reference to purpose in the second limb. But the undertaking or scheme had to be a “profit-making undertaking or scheme”, and a purpose to profit by the carrying on or carrying out of the scheme was taken to be an essential element. In contrast with the first limb, the second limb looked not to the immediate purpose, but to the ultimate purpose of the taxpayer. This would appear to have been established by *Bidencope* (1978) 140 C.L.R. 533, rejecting the view of Gibbs J. in *XCO Pty Ltd* (1971) 124 C.L.R. 343. A conclusion as to the nature of the ultimate purpose might have excluded the operation of the second limb because the purpose found was not a profit purpose. And that conclusion might have excluded the operation of the second limb for another reason. It might have shown that the undertaking or scheme did not involve a “business deal”—the notion imported into the second limb by the decision
in the Privy Council in *McClelland* (1970) 120 C.L.R. 487. In *Bidencope* the ultimate purpose in acquiring the debts and obtaining payment of them was the protection of the taxpayer shareholder against a claim to the profits of the company by the continuing shareholders. In the light of this ultimate purpose, the transaction did not have the quality of a business deal. In the language adopted by Barwick C.J. in *Hamblin* ([3.50] above), the taxpayer did not “trade in or with” the debts.

3.60 Observations by Gibbs and Jacobs JJ. in *Macmine* would appear to establish that the ultimate purpose which the second limb required is as much subjective as the immediate purpose with which the first limb was concerned.

3.61 The requirement of “profit-making” and the requirement of “business deal” were clearly interrelated, so that in most circumstances both would be satisfied or not satisfied. But in the case where the realisation of property was held not to be a business deal because it was merely an “advantageous realisation”, there would appear to have been profit-making but no business deal. Even in such a case there was a disposition to preserve the inter-relationship between profit-making and business deal by assertions that the transaction was one of “money-making” and not “profit-making”: *White* (1968) 120 C.L.R. 191 per Barwick C.J.

3.62 In *McClelland* (1970) 120 C.L.R. 487, the ultimate purpose was held by the Privy Council to be a purpose of holding as distinct from selling at a profit. The Privy Council restored the view of the facts taken in the High Court ((1969) 118 C.L.R. 353) by Windeyer J. at first instance and by Barwick C.J. in the Full Court, and rejected the view of the facts taken by Kitto J.

**Undertaking or scheme**

3.63 Prior to *McClelland* (1970) 120 C.L.R. 487 and the importation of the notion of business deal, the interpretation of the words “undertaking or scheme” concentrated on the degree of complexity that was necessary to make what was done an “undertaking or scheme”. *Clowes* (1954) 91 C.L.R. 209 insisted that merely to outlay money in the hope of more in return was not enough. Otherwise, every casual bet or purchase of a lottery ticket might have been caught by the second limb of s. 26(a). On the other hand in *Official Receiver in Bankruptcy (Fox's case)* (1956) 96 C.L.R. 370 the reclamation, development and sale of land were held to be an undertaking or scheme. In *Fox's case* it was assumed that the second limb might be satisfied in circumstances where the ordinary usage notion of income, applicable to an isolated venture, would not have been satisfied.
However, Taylor and Owen JJ. in *White* (1968) 120 C.L.R. 191 at 219, in the High Court, anticipating *McClelland* in the Privy Council, insisted that “it is not to be thought that the mere realisation of a capital asset not acquired for the purpose of profit-making by sale would constitute a scheme for the purposes of . . . s. 26(a) even though the realisation is effected in the most advantageous manner”. Though the judgments of the High Court did not expressly say so, the court was importing into the second limb an aspect of the business deal notion recognised in the United Kingdom in relation to adventure in the nature of trade. The High Court put the emphasis on the need to satisfy the requirement of profit-making, but the result can also be explained in terms of the requirement of a business deal.

3.64 The recognition of the doctrine of advantageous realisation as part of the law expressed in the second limb of s. 26(a), and the associated recognition of a requirement of business deal, came near to relegating the second limb to a role as a partial statement of the ordinary usage notion of income applicable to an isolated business venture. It would follow, on the correlation between ordinary usage and s. 26(a) adopted by Gibbs C.J. and Mason J. in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355, that it was left with no field in which to operate. It could of course be only a partial statement of the ordinary usage notion. A number of restrictive interpretations of the second limb ensured that this was so.

3.65 There is in any event considerable difficulty in finding in the interpretation of the second limb any aspect that would have given it an operation beyond the ordinary usage notion of an isolated business venture, and thus given it a field of its own. A subjective purpose might have given the quality of profit-making scheme though the objective inference of profit-purpose, which may be thought to be required by the ordinary usage notion, could not be drawn. An ultimate purpose might have given the quality of profit-making scheme when the inference of purpose required by the ordinary usage notion is an inference of immediate purpose to profit. But there is no illustration of either observation in the cases. It may be that the doctrine of advantageous realisation was a more limited qualification in relation to the second limb than in relation to the ordinary usage notion. There was then a prospect that circumstances would amount to a second limb scheme because the scope and complexity of a development operation took it out of the notion of advantageous realisation for the purposes of that limb, when they would not take it out of virtually the same notion for purposes of the ordinary usage notion of isolated business venture. Apart from *Whitfords Beach*, the decisions of the High Court in relation to the advantageous realisation doctrine have been concerned with that doctrine.
in the context of the operation of s. 26(a), and there has been no discussion whether circumstances that would have gone beyond advantageous realisation for purpose of s. 26(a) would also go beyond advantageous realisation for purposes of ordinary usage. In *N. F. Williams* (1972) 127 C.L.R. 226 it was held that a subdivision and sale of property, even though it involved the provision of roads and services, was yet only an advantageous realisation. In the same case there is a statement by Menzies J. that if the development had extended to the building of houses on the subdivided land, the second limb would have been attracted. In *McClelland* (1970) 120 C.L.R. 487 the conclusion by the majority in the Privy Council that the taxpayer's purpose was to hold, precluded the application of the second limb. It does seem, however, that had there been a purpose of profit-making, the facts would have attracted the operation of the second limb. Those facts involved a taxpayer who owned a half interest in land acquiring the other half interest and selling the land in subdivision. The doctrine of advantageous realisation would not have precluded the operation of the second limb. But in no case was any distinction drawn between advantageous realisation in the context of ordinary usage and advantageous realisation in the context of the second limb of s. 26(a).

3.66 It may be that the “planned, coherent and organised” activity (*Official Receiver in Bankruptcy* (Fox's case) (1956) 96 C.L.R. 370 at 381), reflecting some system and organisation, which would have amounted to a scheme for purposes of the second limb, will not be enough to amount to an isolated business venture for purposes of the ordinary usage notion. There is some suggestion of this in the High Court judgments in *Official Receiver in Bankruptcy* (Fox's case). But the authorities offer no help in determining the point where the circumstances showed a scheme but not yet an isolated business venture.

3.67 The recognition in *Whitfords Beach* that the isolated business venture aspect of ordinary usage is part of the concept of income for purposes of the Assessment Act, has made a close consideration of the meaning of the second limb generally unnecessary. If the views of Gibbs C.J. and Mason J. in *Whitfords Beach* are accepted, the isolated business venture aspect of ordinary usage over its field simply displaced the operation of s. 26(a) in either of its limbs. There was, it seems, no room any longer for a view that s. 26(a) covered a field and within that field excluded the operation of the ordinary usage notion. At one time almost all judgments of the High Court concentrated decision on a question of operation of s. 26(a), and ignored the possible operation of ordinary usage. In doing this the court left the impression that the field of s. 26(a) prevailed over ordinary usage, so that restrictive interpretations of some of the words of s. 26(a) might have had
the effect of denying the income character of a profit, and yet excluded the operation of ordinary usage to give income character to that profit. *Whitfords Beach*, in the result, is a decision that the second limb of s. 26(a) was without function, unless it could be shown that in some respects of its operation it was in a field beyond the field of the ordinary usage principle. The prime difficulty, in terms of barriers set by judicial decision, in finding a field for the second limb beyond ordinary usage was the importing of the notion of business deal into s. 26(a) by the Privy Council in *McClelland*. That importing, if accepted, prevented there being any distinct field for the second limb.

**Advantageous realisation is not a scheme**

**3.68** The notion of advantageous realisation has been examined in [2.501] above in relation to that aspect of the ordinary usage meaning of income concerned with an isolated business venture. Reference has already been made to it in [3.25] above. Until now, discussion has focused on a possibility that the notion of advantageous realisation was a lesser qualification on the second limb of s. 26(a) than it is on the doctrine of isolated business venture. In one respect, however, it may have been a greater qualification on the operation of the second limb than on the ordinary usage doctrine. Jacobs J. in *Macmine Pty Ltd* (1979) 53 A.L.J.R. 362 contemplated that, in relation to the second limb, the advantageous realisation of property might include the acquisition of additional property which was itself realised. Jacobs J. would attach the advantageous realisation purpose to the acquisition of the property acquired as a step in the realisation of the original property, so that the operation of the first limb of s. 26(a) was precluded. The view of Jacobs J. would have given the notion of advantageous realisation a very wide operation indeed. Despite Menzies J. in *N. F. Williams* (1972) 127 C.L.R. 226, the building of houses on land as a step in the development and sale of land would have been within the notion. And the acquisition and sale of other land which might conveniently have been developed with the original land will have been simply a step in an advantageous realisation, at any rate if it would enhance the price that could be obtained for the original land. The view of Jacobs J. did not have the support of other members of the court in *Macmine*. Gibbs J. took the view that there was no scheme to profit, because the shares had not been acquired with an immediate purpose of profit-making. Had he found they had been acquired with such a purpose, he would, it seems, have held that there was a profit-making undertaking or scheme within the second limb and not an advantageous realisation.
Acquisition of property and commencement of the scheme

3.69 Barwick C.J. took the view, for example in Steinberg (1975) 134 C.L.R. 640, that the undertaking or scheme had to be formulated no later than the moment of acquisition of the property in relation to which the scheme would be carried out. In Steinberg he said (at 688):

“... a scheme of realisation of an asset not contemplated at the time of its acquisition but subsequently conceived and formulated, is not a scheme within the scope of the second limb of the section ... there must be an identifiable specific scheme existing at the date of the acquisition of the property which is to be used to execute the scheme to make a profit.”

Such a view did not appear to be directed by any of the words of the second limb, though the words of s. 52 lent some support. The view was not endorsed by other members of the High Court. Indeed it was rejected by Menzies J. in N. F. Williams and by Stephen and Gibbs JJ. in Steinberg.

3.70 It will be recalled that in relation to the first limb Barwick C.J. took the view that the acquisition had to be by way of purchase. He considered that this was required because what was taxed was a profit, and there could not be a profit unless there was a cost. He did not, however, take the same view in relation to property acquired in carrying out a scheme. At one stage—at the time of White (1968) 120 C.L.R. 191 and McClelland (1969) 118 C.L.R. 353—such a view in relation to the second limb might be thought to have been dictated by another view he had expressed: he had said in McClelland (at 371) that if land acquired by inheritance is adventured “as the capital of a business, for example, of land jobbing or developing”, no part of the value of the inheritance will be deductible in determining the income of that business. Insisting that the second limb of s. 26(a) required acquisition by purchase would have avoided an unfair consequence of this kind. More recently however, in N. F. Williams, Barwick C.J. abandoned the view expressed in McClelland, and the need to escape the unfair consequence has gone.

3.71 The subjective approach which, it was thought, applied to the question of “profit-making”, would also appear from Macmine Pty Ltd (1979) 53 A.L.J.R. 362 to have been applicable to the question of “undertaking or scheme”. It was the taxpayer's actual planning of his actions that was relevant, not the objective inferences that might be drawn from those actions.

3.72 The subjective approach raised questions as to the extent of planning that had to subsist at the time of commencement of the scheme, and as to the consequences of a change of planning. In Steinberg, Barwick C.J. said (at 687): “While it need not be fully conceived in all its details at the time
of acquisition it must exist as a scheme which in principle embraces all the
details yet to be worked out.” The other judges in that case, Stephen and
Gibbs JJ., required rather less detailed planning at the time of
commencement. Gibbs J. (at 699) said: “if the scheme had the requisite
purpose it was a profit-making scheme notwithstanding that the exact
manner in which the profit was to be made had not been finally decided.”
Other authority, in particular that of Windeyer J. in Buckland (1960) 34
A.L.J.R. 60, is in line with Stephen and Gibbs JJ. The question of the
necessary degree of detailed formulation was of less significance so long as
the view of Barwick C.J. that the scheme must subsist at the time of
acquisition of property subject to the scheme was not followed. But
insufficient planning would, at the least, have deferred the moment when
the valuation of any property subject to the scheme was to be made. And
the exclusion of action prior to the moment of adequate formulation of the
scheme might have prevented the scheme satisfying the requirement of
business dealing. On facts such as were found by Kitto J. in McClelland,
there was probably a business deal, but if the scheme to sell had not been
held to commence till after the acquisition of the interest of the other tenant
in common, the scheme would have been only an advantageous realisation
and not a business deal.

3.73 On the view taken by Barwick C.J., a change in planning was more
likely to have put an end to the scheme—to abort the scheme—and would
have raised the prospect that the planning after the change did not amount
to a business deal. This was the outcome in Kratzmann (1970) 44 A.L.J.R.
293. The less detailed planning required to constitute a scheme, on the
view taken by other judges, lessened the prospect of abortion.

3.74 There was thus a notable difference between the operation of the
second limb and the operation of the first limb. Once property had been
acquired with a purpose, at the time of acquisition, of profit-making by
sale, the operation of the first limb could only be prevented by the taxpayer
failing to sell the property.

3.75 The subjective approach to the question of the existence of a scheme
gave rise to problems of the kind discussed in [3.32] above in relation to
the first limb.

3.76 The scheme had to be carried out by the taxpayer. Observations made
in relation to the first limb in [3.38] above are equally applicable here.

The calculation of profit

3.77 Where property to which a second limb scheme related had been
acquired otherwise than by way of arm's length purchase, or where the
scheme commenced at a time subsequent to acquisition, the cost of the property for purposes of calculating the profit subject to tax was the market value at the time of acquisition or commencement of the scheme. Kitto J. in McClelland (1969) 118 C.L.R. 353 proceeded on this principle in remarking that the Commissioner had been generous in assuming that the market value of the taxpayer's half interest was half the proceeds of sale of the merged interests.

3.78 Observations made in [3.39]ff. above in relation to the first limb have relevance to the second limb. In McRae (1969) 121 C.L.R. 266, the taxpayer argued that the value of his shares had been increased by a gift—the sale of the flats at an undervalue—made not to him but to the company in which he held his shares. The court found that the sale to the company had been made at full value. If it had been found that there was an element of gift, this would have been relevant to the determination of the profit derived by the taxpayer on the sale of his shares.

3.79 In McRae an argument that the amount paid up on the bonus shares issued by the company should be treated as a cost in determining the taxpayer's profit from the scheme, was rejected by the High Court. The rejection of the argument, one would have thought, was inevitable having regard to the decision in Gibb (1966) 118 C.L.R. 628 that there is no derivation of income in a bonus issue that is within s. 44(2). A similar argument in the context of share trading operations was however upheld in Curran (1974) 131 C.L.R. 409, to which reference is made in [6.194]ff., [7.24]ff. and [12.78]ff. The provisions of s. 6BA, introduced to reverse the effect of Curran, applied to a s. 26(a) situation.

The correlation of isolated business venture and section 26(a)

3.80 Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355 went a substantial way towards an answer to the question of the correlation between the operation of the ordinary usage meaning of income expressed in the notion of an isolated business venture and the meaning of income supplied by s. 26(a). Whitfords Beach establishes that the notion of an isolated business venture supplies some part of the meaning of income for purposes of the Assessment Act. As recently as Macmine Pty Ltd (1979) 53 A.L.J.R. 362, the assumption both of the Commissioner and all judges, including Sheppard J. at first instance, would appear to be that the ordinary usage meaning supplies principles relevant only to a continuing business operation, and principles of the ordinary usage meaning relating to an isolated business venture are not part of our law. But an assumption which is not contested by the parties does not make law. Against the assumption
in *Macmine* was an observation by Windeyer J. in *White* (1968) 120 C.L.R. 191 at 212 that s. 26(a) “does not . . . make ‘not income’ any sums, or parts of sums, which would on general principles be income”. The view of Gibbs C.J. and of Mason J. is that where the ordinary usage principles applicable to an isolated business venture were attracted s. 26(a) was denied any operation. But the precise field of operation of the isolated business venture remains to be settled. Some comment in this regard is offered in [3.8].

**The Development of the Law by Section 25A**

3.81 In 1984 s. 26(a) was repealed and a new s. 25A added to the Assessment Act. The new section, in subs. (1), repeats the words of s. 26 (a). The manner of the repeal and new enactment calls for some comment. Act No. 47 of 1984, by s. 11(a) and s. 60(8), repealed s. 26(a) of the Assessment Act retrospectively, save in one respect, so that s. 26(a) has no effect in relation to sales of property after 23 August 1983. This repeal is not retrospective, however, in so far as it relates “to the carrying on or carrying out of any profit-making undertaking or scheme”. The repeal of s. 26(a) so far as it relates to a profit-making undertaking or scheme has effect from the date of Royal assent: Act No. 47, s. 2. Royal assent was given on 25 June 1984. Sections 10 and 17 of Act No. 47, which inserted the new s. 25A in the Assessment Act and added subsections to s. 52, have a retrospective operation so that the new provisions apply in general to sales of property after 23 August 1983. But the new provisions do not have a retrospective operation “in so far as they relate to the carrying on or carrying out of any profit-making undertaking or scheme”. So far as the new provisions relate to a profit-making undertaking or scheme, they have effect from the date of Royal assent.

3.82 Comment on the significance of the manner of repeal of s. 26(a) and of the enactment of s. 25A is made in [3.12]–[3.13].

3.83 It may be assumed that s. 25A(1), in adopting the exact words of s. 26 (a), has confirmed the judicial interpretation of s. 26(a) explored in the background survey in immediately preceding paragraphs. It has, by a number of deemings in subss (2)–(12), corrected what were thought to be unacceptable aspects of that interpretation. The deemings do not however affect the validity of the assumption. Indeed they reinforce it. It follows that save where its operation is subject to a deeming, and then only to the extent of the specific terms of that deeming, s. 25A(1) will apply with the interpretations given by the courts to s. 26(a), and to any further development of those interpretations. And it may be assumed that, save
where the subsections added to it make different provision, s. 52 will continue to receive the interpretation already given to subs. (1) of the section, in particular the interpretation given to that subsection in Werchon (1982) 82 A.T.C. 4332 referred to in [3.54] above.

The transactions covered by subsections (2) to (12) of section 25A and subsections (2) to (5) of section 52

3.84 The added subsections of ss 25A and 52 deal with five kinds of transactions:

(I) A taxpayer sells shares in a company or an interest in a partnership or an interest in a trust estate, which he did not acquire for the purpose of profit-making by sale. The company, partnership or trust estate, however, held property at the time of the sale that was acquired for the purpose of profit-making by sale. Transaction (I) is illustrated by the facts of Hobart Bridge Pty Ltd (1951) 82 C.L.R. 372. The relevant provisions are subss (2), (3), (7), (10)(a), (11) and (12) of s. 25A and s. 52(5)(b). They might be described as the Hobart Bridge amendments.

(II) A taxpayer who actually acquired property for the purpose of profit-making by sale, or is deemed to have acquired property for that purpose by the operation of s. 25A, sells the property in a non-arm's length transaction for less than its value, or makes an inter vivos gift of the property, or, being a company, partnership or trust estate, distributes the property: these transfers are referred to as transfers “in the prescribed manner”. Thereafter the transferee disposes of the property. The relevant provisions are subss (5), (9) and (10)(b) of s. 25A and subss (2), (3) and (5)(a) of s. 52. They might be described as the N. F. Williams amendments.

(III) A taxpayer who actually acquired property for the purpose of profit-making by sale, or is deemed by the operation of any provision of s. 25A to have acquired property for that purpose, sells an interest in the property, or sells property in which the property acquired has become merged. The relevant provisions are subss (6), (9), (10)(c), and (12)(d) of s. 25A and s. 52(4). They might be described as the identity doctrine amendments.

(IV) Transaction (IV) involves elements of transactions (II) and (III). A taxpayer actually acquires property for the purpose of profit-making by sale or is deemed by the operation of any provisions of s. 25A to have acquired property for that purpose, and thereafter disposes of an interest in the property, or disposes of property in which the property acquired has become merged. The disposition is a sale of the property for less than the value of the property in a non-arm's length sale, an inter vivos gift of the property, or, where the taxpayer is a company, partnership or trust estate, a
distribution of the property. The relevant provisions are subss (6), (8), (9), (10)(c) and (11) of s. 25A and subss (2), (3) and (5)(a) of s. 52.

(V) A taxpayer actually acquires shares in a company for the purpose of profit-making by sale, or is deemed by the operation of any provisions of s. 25A to have acquired shares for that purpose, and the company makes a bonus share issue or a rights issue to the taxpayer. The relevant provisions are subss (4), (9), (10)(d) and (e) of s. 25A. They might be described as the Miranda amendments.

Sale of shares in a company, or an interest in a partnership, or an interest in a trust estate where the company, partnership or trust estate at the time of the sale holds property that was acquired for the purpose of profit-making by sale: Transaction (I)

3.85 In Hobart Bridge (1951) 82 C.L.R. 372 the taxpayer held shares in a subsidiary company. Those shares had not been acquired for profit-making by sale. The subsidiary acquired land for the purpose of profit-making by sale. Thereafter the taxpayer sold its shares in the subsidiary. The High Court held that the taxpayer had not derived a profit that was income on the sale of those shares. The provisions of s. 25A that are directed to circumstances of this kind are subss (2), (3), (7), (9), (10)(a), (11) and (12) of s. 25A and s. 52(5)(b). They have some affinity with provisions that have appeared since 1982 in s. 26AAA, to which reference is made in [3.174]–[3.189] below.

3.86 The provisions apply not only to the holding of shares in what might be called an intermediary company, but also to the holding of an interest in an intermediary partnership or an intermediary trust estate. The property acquired by the intermediary for the purpose of profit-making by sale may be identified as the underlying property.

3.87 The intermediary company or trust estate must be a private company or private trust estate as defined in s. 25A(12). The holding of shares in the company, or an interest in the partnership or trust estate, may have commenced at any time, though the sale of the shares or interest must have occurred while the underlying property was held by the intermediary. The operation of s. 25A(2)(a) is to deem the shares or interest to have been acquired by the taxpayer for the purpose of profit-making by sale.

3.88 Property acquired for the purpose of profit-making by sale may have been held not by the intermediary, but by a sub-intermediary, and the phrase “underlying property” may be applied to that holding. If at the time of sale by the taxpayer the intermediary held an interest through one or more interposed companies, partnerships or trusts—which need not be private companies or trusts—in property acquired for profit-making by sale
by another private company, partnership or trustee of a private trust estate, s. 25A(2)(b) will deem the taxpayer to have acquired the shares or interest in the intermediary for the purpose of profit-making by sale.

3.89 The taxpayer will be deemed to have acquired for the purpose of profit-making by sale “for the purposes of the application of the [Assessment] Act”. That deeming will bring the circumstances within the field of the first limb of s. 25A(1), if they are not already within that field. They will not however bring the taxpayer within the field of income by ordinary usage or the field of the second limb of s. 25A(1). And they will not prevent the exclusive operation of ordinary usage or the second limb if the circumstances otherwise lie within the fields of ordinary usage or of the second limb. These assertions follow from the views expressed in [3.6]–[3.14] above as to the correlation between the ordinary usage concept of income and s. 25A, and the correlation between the two limbs of s. 25A(1).

3.90 The deeming will presumably operate even though the taxpayer is already within the field of the first limb, because he actually acquired for profit-making by sale. But the deeming is simply irrelevant if the taxpayer is already within the field of the ordinary usage concept, or the field of the second limb of s. 25A(1).

3.91 The intermediary or sub-intermediary must at the time of sale by the taxpayer hold the underlying property as property acquired for the purpose of profit-making by sale, and the underlying property must not be “excepted property”. At first view, the holding by the intermediary should be a holding or deemed holding within the field of the first limb of s. 25A(1), which could not, on the views expressed in [3.6]–[3.14] above, be a holding that attracts the operation of the ordinary usage meaning of income or the second limb of s. 25A(1). A difficulty is however created by the definition of “excepted property” in s. 25A(12), which extends to trading stock, so that a holding of trading stock by the intermediary cannot engage the operation of s. 25A(2). It is true that the words “trading stock” will most often describe property acquired for the purpose of profit-making by sale, though, as explained in [14.38]ff. below, items may be trading stock as items taken into a business of trading though they were not acquired for profit-making by sale. If the inference is drawn from the definition of excepted property that the intermediary for purposes of s. 25A(2) may hold property acquired for the purpose of profit-making by sale even though it does not hold that property in circumstances within the field of the first limb of s. 25A(1), it ought not to be held to follow that s. 25A has a field which overlaps with or shuts out the operation of ordinary usage. The definition of “excepted property” was imported into s. 25A from s. 26AAA(1)(m). It was imported from a section that is applicable to circumstances
within the field of the ordinary usage principles, though s. 26AAA(5)(a) excludes the operation of s. 26AAA if, as a result of a sale, a profit will be income of a business carried on by a taxpayer.

3.92 One consequence of trading stock being excepted property is a confirmation of a conclusion that would have followed in any event, that s. 25A(2) has no operation in the very circumstances of *Hobart Bridge Pty Ltd* (1951) 82 C.L.R. 372 where, at least since *St Hubert's Island Pty Ltd* (1978) 138 C.L.R. 210, the land held by the intermediary would be held as trading stock.

3.93 Where a taxpayer is deemed by s. 25A(2) to have acquired for the purpose of profit-making by sale “so much (if any) of the proceeds of sale as, in the opinion of the Commissioner, is appropriate shall, for the purposes of the [Assessment] Act, be deemed to be profit arising from the sale by the taxpayer on the property”: s. 25A(9). Presumably the Commissioner has the function given him by subs. (9), even though the taxpayer in fact acquired the property for the purpose of profit-making by sale. But s. 25A(2) should not be interpreted so that its operation is attracted where the shares or interest held by the taxpayer are held in circumstances that are within the field of ordinary usage principles. Such an interpretation would reject the views expressed in [3.6]–[3.14] above, and it would lead to unmanageable consequences. Thus the taxpayer may be a share-trader who includes in his stock unlisted company shares. A function vested in the Commissioner to determine a profit that will be income cannot be reconciled with the operation of the trading stock provisions. It is not a sufficient answer that the Commissioner could forsake his function by the exercise of another function provided for in s. 25A(3)(b).

3.94 The Commissioner is directed by s. 25A(10)(a) to have regard to a number of matters in determining the profit, where s. 25A(2) operates to deem the taxpayer to have acquired for the purpose of profit-making by sale. The direction is confined to circumstances where the underlying property was actually acquired by the intermediary for the purpose of profit-making by sale, and the shares or interest deemed to have been acquired by the taxpayer for the purpose of profit-making by sale were not “transferred to the taxpayer in the prescribed manner”. Prescribed manner is defined in s. 25A(11). It extends to transfers by way of inter vivos gift, transfers at less than value between taxpayers who are not at arm's length, and distributions by a private company or private trust estate. The reasons for the exclusion of the direction given by s. 25A(10)(a) where the intermediary did not actually acquire for profit-making by sale is not apparent. The reason for excluding circumstances where the taxpayer
acquired in a transfer in the prescribed manner is, presumably, to allow the Commissioner in the exercise of his function under s. 25A(9) to proceed uninhibited by s. 25A(10)(a). He may thus have regard to the increase in value of the underlying property, not only during the time the shares or interest were held by the taxpayer, but also during the time the shares or interest were held by the transferor to the taxpayer.

3.95 The Commissioner is directed to have regard to the extent to which, in his opinion, the proceeds of sale of the shares or interest derived by the taxpayer are attributable to the amount of any increase in the value of the underlying property during the period which is common to both the holding of the underlying property by the intermediary and the holding of the shares or interest by the taxpayer. The amount of the increase in value is however to be reduced for the purpose of the calculation by any capital expenditure incurred by the intermediary in respect of the underlying property, excluding expenditure in respect of which a deduction has been allowed or is allowable to the intermediary.

3.96 Section 25A(10)(a) does not require the Commissioner to confine his attention to the matters stated. He should have regard to the prospect that tax will be paid by the intermediary on the increase in value of the underlying property when that property is sold, s. 25A being applicable. The proceeds of sale by the taxpayer of its shares or interest will not fully reflect the increase in value of the underlying property where the sale of the underlying property will generate a tax liability on the intermediary.

3.97 Section 25A(10)(a) is applicable whether the increase in value referred to is an increase in value of underlying property held by a first intermediary, or held by a sub-intermediary. Clearly, however, the Commissioner could not properly attribute to the proceeds of sale the whole of each of these increases in value of underlying property. At least some part of the increase in value of property held at the sub-intermediary level will be reflected in the increase in value at the first intermediary level, and is taken into account in attributing proceeds of sale to the latter.

3.98 Section 25A(7) adopts the drafting of subs. (6), considered in [3.134]–[3.141] below, intended to overcome the identity doctrine which limited the operation of s. 26(a), so that an intermediary company, partnership or trust will be deemed to have acquired property for profit-making by sale where (i) it holds property which is an interest in property acquired by it for the purpose of profit-making by sale; or (ii) it holds property in which was merged an interest in property acquired by it for the purpose of profit-making by sale. The property deemed to have been acquired for the purpose of profit-making by sale is in the first instance the interest in the property acquired for the purpose of profit-making by sale, and in the
second instance the property in which the property acquired for the purpose of profit-making by sale has merged. The deeming by s. 25A(7) is for the purpose of s. 25A(2). The inference is that s. 25A(6) would not have brought about a deeming for purpose of s. 25A(2), and there is a further inference that s. 25A(5), (8) and (4), considered in [3.143]–[3.159] below, would not bring about a deeming for purpose of s. 25A(2).

3.99 The express provision in s. 25A(7) must have been moved by an assumption that the deeming provisions of subss (6), (5), (8) and (4) of s. 25A are applicable only to the affairs of the person whose assessable income is to be determined, identified by those provisions as “the taxpayer”.

3.100 The identity doctrine is thus overcome by s. 25A(7) where the question is whether an intermediary has acquired property for the purpose of profit-making by sale, but N. F. Williams (1972) 127 C.L.R. 226 and Miranda (1976) 76 A.T.C. 4180 are not. Thus the calculation of a profit under the direction given to the Commissioner by s. 25A(10)(a) will not take into account an increase in value of bonus shares or rights issued to the intermediary in respect of a holding of shares. Nor will it take into account an increase in the value of property acquired by the intermediary in a prescribed transfer from a person who acquired for the purpose of profit-making by sale.

3.101 The overcoming of the identity doctrine by s. 25A(7) has a consequence that may not have been intended. The calculation of a profit under the direction given to the Commissioner by s. 25A(10)(a) will take into account an increase in value of the whole property deemed to have been acquired for profit-making by sale, though it results from the merger of properties only one of which was acquired for profit-making by sale.

3.102 Section 25A(3) gives the Commissioner a function to lift the operation of s. 25A(2) where he considers that it is not appropriate that it should apply. He is directed to have regard, inter alia, to the extent to which the assets of the intermediary immediately before the sale by the taxpayer consisted of underlying property, and the nature and extent at that time of the taxpayer's control of the intermediary.

Disposition in the prescribed manner of property acquired or deemed to have been acquired for the purpose of profit-making by sale: Transaction (II)

3.103 The description of Transaction (II) tends to hide the great complexity to which subss (5), (9), (10)(b) and (11) of s. 25A and subss (2), (3) and (5) (a) of s. 52 give rise. These provisions, which may be described as the N. F. Williams amendments, apply not only to a taxpayer who actually
acquired for the purpose of profit-making by sale, but, save where there is, in some particular, a clear indication to the contrary, also to a taxpayer who is deemed by the operation of these provisions to have acquired for this purpose. And any operation of these provisions will lay the basis for their further operation in relation to another taxpayer, or will lay the basis for the operation of any other provision which depends for its operation on another taxpayer having acquired for the purpose of profit-making by sale.

3.104 The general effect of the provisions referred to is that where a taxpayer takes property under a transfer in the prescribed manner made by a person who actually acquired the property for the purpose of profit-making by sale, or made by a person who is deemed under the provisions or any other provisions of s. 25A to have acquired the property for the purpose of profit-making by sale, the taxpayer is deemed to have acquired the property transferred to him for the purpose of profit-making by sale so that a sale of the property by him will attract the operation of the first limb of s. 25A(1). The deeming will not, on the view taken in paras [3.6]–[3.14] above, have any effect in supplying an element which may be necessary for a conclusion that the taxpayer has entered on a profit-making undertaking or scheme, so that he might come to derive income under the second limb of s. 25A(1). Moreover the acquisition by the transferor for the purpose of profit-making by sale that is required if subs. (5) is to operate, must be an acquisition within the field of operation of the first limb of s. 25A(1). Section 25A(5) can have no operation if a transfer in the prescribed manner is made by a person who holds property as trading stock, as a revenue asset of a continuing business, as an asset of an isolated business venture or as an asset of a profit-making undertaking or scheme. This would follow from the views expressed in [3.6]–[3.14] above as to the correlation between the ordinary usage concept of income and s. 25A, and the correlation between the two limbs of s. 25A(1). The views gain support from an examination of the difficulty that would be involved in seeking to apply the provisions of s. 25A(10) (b) in determining the profit that is income where the transferor's actions were within a field other than the field of the first limb of s. 25A(1). Section 25A(10)(b) is considered in [3.108]–[3.127] below.

3.105 In the case of trading stock, there is an express provision in the definition of “excepted property” that casts a shadow on these submissions. A transfer in the prescribed manner for purposes of subs. (5) includes a transfer by way of a distribution of property of a private company or private trust estate, but not where a transfer is made of “excepted property”. Excepted property is defined so that it includes trading stock of the company or trustee. It might be argued that the inference from the express exception is that the transferor's holding of property need not have
been acquired within the field of operation of the first limb of s. 25A(1), or, indeed, that the inference is that the field of operation of the first limb will embrace any circumstances that can be described by the words “acquired for the purpose of profit-making by sale”. Neither is a necessary inference. The definition of “excepted property” is taken in relevant respects from the definition in s. 26AAA(1)(m). Its function in the context of s. 26AAA is explained in [3.182] below, and, in the parallel context of s. 25A(2), in [3.91] above. If an inference of the kind suggested were intended, there should have been an express provision in the definition of transfer in the prescribed manner, so that a transfer by way of gift, or for less than value in a dealing not at arm's length, would not have included a transfer of excepted property.

3.106 An inference that s. 25A(5) has no application where a transferor held property as trading stock, an inference to be drawn from the impossibility of any sensible application of s. 25A(10)(b) in such circumstances, overcomes any inference to be drawn from the definition of excepted property. A disposition of trading stock in a transfer in the prescribed manner will normally give rise to assessable income in the amount of the market value of the trading stock, and the application of s. 25A(10)(b) will be absurdly distorted. Section 25A(10)(b), in determining the taxpayer's profit that is income, would require an allowance for both the transferor's cost and the amount of the transferor's assessable income arising from the prescribed transfer.

3.107 It will be noted that a transfer in the prescribed manner as defined in s. 25A(11) may include a sale of property. It will include a sale if the Commissioner is satisfied that the transferee and the person who transferred the property were not dealing with each other at arm's length in relation to the transfer of the property, and the property was transferred for consideration the amount or value of which is less than the amount that, in the opinion of the Commissioner, was the value of the property immediately before the time of transfer. It follows that every purchaser of property is at some risk that he will be deemed to have acquired the property for the purpose of profit-making by sale. He is at risk whenever there is any ground for the Commissioner reaching a satisfaction that he and the seller were not dealing with each other at arm's length in relation to the transfer, and there is any ground on which the Commissioner might form an opinion that the value of the property is an amount more than the consideration for the transfer. It will be noted that the Commissioner has two functions—to reach a satisfaction that the purchaser and the seller were not dealing with each other at arm's length, and to form an opinion as to the value of the property. There is some contrast in the result with the
provisions of s. 136AD in relation to international transfer-pricing. Under that provision whether or not the price is an arm's length price is a matter of fact, unless "it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration": subss (1)(c) and (4).

3.108 Where the provisions operate, the Commissioner is given, by subss (9) and (10)(b) of s. 25A, a function to determine the amount of the profit arising from the sale by the taxpayer of the property. The Commissioner has this function whether or not the sale is itself a sale in the prescribed manner. But the fact that a sale is in the prescribed manner is not enough in itself to attract the Commissioner's function. Where a taxpayer has actually acquired property for the purpose of profit-making by sale, and there is no operation of the provisions to deem him in any event to have acquired for profit-making by sale, any profit on the sale of the property by the taxpayer will be determined without the operation of any function of the Commissioner.

3.109 The operation of the provisions in a claimed loss situation is to a degree in parallel. The Commissioner is given a function, by s. 52(2), to determine the amount of a loss on the sale of property by a taxpayer who has acquired under a transfer in the prescribed manner, and this whether or not the taxpayer actually acquired for the purpose of profit-making by sale. Unless the Commissioner exercises his function, no loss will be allowable. This is the consequence of s. 52(3). In this respect there is no parallel with the provisions in regard to a profit, which, at least in theory, leave the determination of a profit on sale to general principles where the Commissioner has not exercised his function. And there is another way in which the loss provisions fail to parallel the profit provisions: a sale in the prescribed manner by a taxpayer who has actually acquired for the purpose of profit-making by sale, but is not deemed to have acquired for the purpose of profit-making by sale, cannot give rise to a loss deduction. Express provision is made to this effect in s. 52(5)(a). Section 52(5)(a), it should be noted, does not exclude the Commissioner's function, where a sale is in the prescribed manner, to allow a loss if the taxpayer is deemed under s. 25A(5) to have acquired for the purpose of profit-making by sale.

3.110 The provisions applicable to Transaction (II) are not only complex but involve a circuitry that might be expected of a lawyer draftsman, but of which an electronics engineer might feel ashamed. It may fairly be asked why the elaborate circuitry was necessary. The background of the provisions is of course the decision of the Full High Court in *N. F. Williams* (1972) 127 C.L.R. 226. A taxpayer could abort the operation of the first limb of s. 26(a) by making a gift to his wife of property he had acquired for the purpose of profit-making by sale where the property had
increased in value. The first limb would have no application to the wife on her subsequent sale of the property, since she could not be said to have acquired “purposively”, that is, for the purpose of profit-making by sale. If it was thought that N. F. Williams showed that the law did not accord with its policy, there were precedents for reform in s. 36 in relation to trading stock, and in s. 26AAA(4) in relation to short-term purchases and sales, that might have been followed. Such provisions prevent the abortion of a transaction that would otherwise have given rise to a profit that was income. Their method is to deem a disposal that is not in the ordinary course of a trading transaction, or in the ordinary course of a purchase and sale, to be a sale at market value. The person who acquires under the disposal is deemed to have acquired at that value. It is true that the method would not, without more, enable the taxing of a further increase in the value of the property that may be realised by the person who took under the disposal. But reform to enable the taxing of that further gain might have been directed to some modification of the principle requiring purposive acquisition, such that a taxpayer might be taken to have acquired for the purpose of profit-making if he accepts a gift inter vivos and his subsequent actions thereafter do not contradict a presumption that he acquired for profit-making by sale.

CHART A

<table>
<thead>
<tr>
<th>Column (1)</th>
<th>Column (2)</th>
<th>Column (3)</th>
<th>Column (4)</th>
<th>Column (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A transfers to B transfers to C</td>
<td></td>
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<tr>
<td>A acquires property as a result of transfer in the prescribed manner: s. 25A prescribed manner from a person “X” who actually acquired for the purpose of profit-making by sale. Profit is income.</td>
<td>A is deemed to have acquired for profit-making by sale: s. 25A(5).</td>
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<tr>
<td>Sells other than in the prescribed manner from a person “X” who actually acquired for the purpose of profit-making by sale. Profit is income.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Commissioner determines profit under s. 25A(9) and profit-making by sale. Loss is allowable: s. 52(2) and (3).</td>
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<td>OR</td>
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<td></td>
</tr>
<tr>
<td>(i) Sells in the prescribed Deemed manner: s. 25A(11).** Profit is income.</td>
<td>to (i) Sells other than in the prescribed manner: s. 25A for (11). Profit is income.</td>
<td>Calculation under s. 25A(9).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commissioner determines profit under s. 25A(9). S. making 25A(10)(b) also applicable. Sale: s. 25A applicable. save, possibly, where A actually acquired for the purpose of profit-making by sale. Loss is allowable: s. 52(2) and (3).</td>
<td>Calculation under s. 25A(9).</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) Sells in the prescribed Deemed manner: s. 25A(11).** Profit have acquired</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>


*(1) If A did not acquire from a person who actually acquired for the purpose of profit-making by sale but acquired from a person who is deemed to have acquired for the purpose of profit-making by sale, the analysis is the same as that above with the difference that s. 25A(10)(b) has no operation in column (2).

**(2) If A does not sell to B, or B does not sell to C, but transfers in the prescribed manner by way of gift inter vivos, or as a private company or private trust estate making a distribution to a shareholder or beneficiary, there will be no profit or loss by A or B. However, B or C will be deemed to acquire for profit-making by sale: s. 25A(5).

3.111 Chart A has attempted to trace the operation of the provisions applicable to Transaction (II) over a series of transfers of property, and some comment is now offered.

3.112 In column (1) it is assumed that A has acquired under a transfer in the prescribed manner from X, a person who actually acquired for the purpose of profit-making by sale. The consequence is that the exercise of the Commissioner's function under s. 25A(9), referred to in column (2), must conform with s. 25A(10)(b), and this, presumably, whether or not X is also a person who is deemed to have acquired for the purpose of profit-making by sale: he may have acquired with an actual purpose of profit-making by sale, though under a transfer in the prescribed manner.

3.113 In columns (2) and (4) it is assumed that the transfers are by way of sale, so as to raise questions as to the arising of a profit that is income or a loss that is deductible. If A does not sell to B, or B does not sell to C, but transfers in the prescribed manner by way of a gift inter vivos, or as a private company or private trust estate making a distribution to a shareholder or beneficiary, there can be no profit or loss by A or B that is income or deductible. However B or C will be deemed to acquire for profit-making by sale: s. 25A(5). And the circumstances of the deemed acquisition by B or C will be relevant to the determination of any profit made by B or C that is income, or of any loss that is deductible by B or C, if there is a subsequent sale by B or C.

3.114 Column (2) distinguishes the situation of a sale other than in the prescribed manner from the situation of a sale in the prescribed manner. In both situations the Commissioner's function to determine the profit is attracted. It will be noted that if the sale in column (2) is not in the
prescribed manner—it is a sale between persons at arm's length and for full value—a following sale by B to C will not attract the Commissioner's function to determine the profit in relation to that sale. At this point the operation of s. 25A in bringing in a profit is an operation of the first limb of s. 25A(1) unaided by any of the further provisions of s. 25A. There will however be an operation of s. 52(5)(a) in relation to the bringing in of a loss if the sale by B to C is a sale in the prescribed manner. It is a mark of the defective circuitry of the new provisions that a loss may be deductible under s. 52(2) where there has been a sale in the prescribed manner if the taxpayer, because of an acquisition in the prescribed manner, is deemed to have acquired for profit-making by sale, but not where the taxpayer has acquired for full value.

3.115 The determination by the Commissioner of the amount of a profit in a column (2) situation is subject to a direction to him by s. 25A(10)(b) to have regard to a number of matters. The direction is however confined to circumstances where the taxpayer (A in the chart) has acquired the relevant property from a person (X in the chart) who actually acquired for the purpose of profit-making by sale. If X in the chart is a person who is deemed to have acquired for the purpose of profit-making by sale, and did not also actually acquire for profit-making by sale, s. 25A(10)(b) has no application, and the Commissioner has power to determine the profit uninhibited by the direction that provision gives. The reason for limiting s. 25A(10)(b) to a situation where X in the chart actually acquired for the purpose of profit-making by sale is not apparent, unless it was intended to select a circumstances where X may be taken to have paid full value for the item of property so that it is not inappropriate to have a calculation of profit based on his actual costs, as the provision may be thought to require. But X may have actually acquired for the purpose of profit-making by sale in a transfer to him at less than the value of the property.

3.116 Alternatively the intention may have been that the s. 25A(10)(b) direction should be available only where X has actually acquired for profit-making by sale, and is not a person deemed by any provision of s. 25A to have acquired for profit-making by sale. Even then it may not be appropriate to base a calculation of profit on X's costs: he may have actually acquired for profit-making in a purchase at less than full value from a person who did not acquire, actually or by deeming, for profit-making by sale.

3.117 The operation of the direction on the transfers to which it applies poses further problems. The Commissioner is directed to have regard to the extent to which the amount “that would have been included in the assessable income of the transferor” (X in the chart) “if [he] had sold the
relevant property at the time when it was sold by the taxpayer” (A in the chart) “for an amount of consideration equal to the amount of the consideration received or receivable by the taxpayer in respect of the sale of the relevant property by the taxpayer, exceeds the sum of” certain specified amounts. The reference to the inclusion of an amount in the assessable income of the transferor is to an inclusion of a profit which would require the subtraction of the transferor's costs. There is no direction as to the identification of those costs though it is likely that actual costs only were intended. Yet if s. 25A (10)(b) extends to situations where the transferor acquired in circumstances where there was both an actual and a deemed purpose of profit-making by sale, the costs should in fairness include any element of gift received by the transferor in his acquisition of the property. Fairness has the support of the decisions in *Bernard Elsey Pty Ltd* (1969) 121 C.L.R. 119 and *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355. And it has the support of the principle that might be thought to stem from those cases, and asserted by Gibbs J. in *Curran* (1974) 131 C.L.R. 409, though, it is submitted with respect, misapplied by him in that case.

3.118 There are other problems in regard to the operation of the direction. The subtractions from the profit that the transferor (X in the chart) would have made, in determining the profit that is income of the taxpayer (A in the chart) include “(i) any expenditure incurred by the taxpayer in respect of the relevant property, not including—(A) any consideration given by the taxpayer in respect of the transfer of the relevant property to the taxpayer; or (B) expenditure to which subpara. (ii) applies . . . ”. The exclusion in (A) is clearly necessary, because of the subtraction allowed by subpara. (iii) of subs. (10)(b) of “the amount of any profit included in the assessable income of the transferor (X in the chart) in respect of the transfer of the relevant property to the taxpayer” (A in the chart). The object, it would seem, is to tax to the taxpayer the balance of the profit the transferor would have made beyond that amount of the profit already taxed to the transferor.

3.119 The provisions of s. 25A (10)(b)(i)(B) are a drafting measure to prevent any double subtraction of amounts that would in effect be within both subparas (i) and (ii). Subparagraph (ii) allows the subtraction of “so much of the consideration received or receivable by the taxpayer” (A in the chart) “in respect of the sale of the relevant property by the taxpayer as exceeds the amount that, in the opinion of the Commissioner, would have been the consideration received or receivable by the taxpayer if the taxpayer had not incurred” certain capital expenditure. The capital expenditure referred to is “expenditure of a capital nature in respect of the relevant property otherwise than—(A) in acquiring property for the purpose of profit-making by sale; or (B) as part of a profit-making
undertaking or scheme”. The intention of para. (ii) is to deal with circumstances where the taxpayer (A in the chart) has, for example, erected a house on land that he is deemed to have acquired for the purpose of profit-making by sale, intending to make the house his home. Subparagraph (ii) contemplates the exclusion from the profit subject to tax, of that element which reflects an increase in the value of the house over its cost. In the result, there may be a profit that is less than the profit that would have been income if there had been an actual acquisition of land for the purpose of profit-making by sale, and no deemed acquisition for that purpose, and the taxpayer, following a change of mind, had built a home on the land and thereafter sold the land and home. It is arguable that general principles of the calculation of profit that is income under the first limb of s. 25A(1) would include the element of profit attributable to the increase in value of the home. A taxpayer may thus find advantage in the deeming that he acquired for the purpose of profit-making by sale.

3.120 There is a question left by subpara. (ii) as to whether expenses in acquiring property for the purpose of profit-making or as part of a profit-making undertaking or scheme are subtractable by the Commissioner in following the direction given by subs. (10). The pattern of drafting is confusing but the interpretation is open that these expenses are subtractable under subpara. (i) as “expenditure incurred by the taxpayer in respect of the relevant property”. But the reference to expenditure incurred “as part of a profit-making undertaking or scheme” poses a question of the correctness of the view taken above that none of the provisions of subss (2)–(12) of s. 25A has any application where the circumstances involve a profit-making undertaking or scheme within the second limb of s. 25A(1). Subparagraph (ii) contemplates expenditure in a scheme which commenced after the acquisition of the relevant property, for example a scheme to build houses for sale on land acquired for the purpose of profit-making by sale. A rigid separation of the operations of the first and second limbs of s. 25A(1) would require a distinct calculation of the profit from the scheme, a calculation that does not draw on subss (2)–(12) of s. 25A and no subtraction of the expenditure in determining the profit from the first limb transaction. There would need to be some apportionment of the proceeds of sale to determine the amounts referable respectively to the first limb and to the second limb transactions. Indeed, there should in theory be a separation of the first limb transaction that began with the acquisition of the land and the first limb transaction that began with the acquisition of the house. The transaction that began with the acquisition of the house would not attract a deeming of acquisition for profit-making by sale, though the transaction that began with the acquisition of the land has done so.
3.121 Two final observations on s. 25A(10)(b) may be appropriate. The calculation of the profit that would have been made by the transferor (X in the chart) if he had sold at the time of sale by the taxpayer (A in the chart) assumes a method of accounting that would bring in the consideration received and the consideration receivable by the taxpayer. The language used contrasts with the language in other paragraphs of s. 25A(10). In para. (a) the reference is to “proceeds of sale”. And it contrasts with the general provision, in subs. (9), which also refers to “proceeds of sale”. The phrase “proceeds of sale” admits of a method of accounting that would be designated profit-emerging. But para. (b) of s. 25A(10) does not.

3.122 The second observation concerns the operation of subpara. (iii) which provides for the subtraction of any profit taxed to the transferor in determining the profit to be taxed to the taxpayer. The profit taxed to the transferor may be a profit that is assessable income of the transferor under s. 26AAA if purchase and sale by the transferor occurred within 12 months. The operation of s. 25A does not preclude the operation of s. 26AAA and the transferor's profit will be calculated by reference to a sale price determined by s. 26AAA(4). Where the Commissioner is satisfied that transferor and the taxpayer were not dealing with each other at arm's length, the transferor is deemed to have sold for an amount that in the opinion of the Commissioner was the value of the property. The taxpayer is deemed to have acquired for a consideration equal to that amount. The deemed consideration provided for in s. 26AAA(4) will not be relevant where s. 25A(10)(b) operates but the deemed proceeds of sale by the transferor raises the possibility that the resulting profit to the transferor may exceed the proceeds of sale by the taxpayer that remain after other subtractions. There is no provision whereby that excess may be treated as mitigating the profit that may arise on a subsequent sale by the person (B in the chart) who took from the taxpayer. The deemed consideration provided for in s. 26AAA(4) will not be relevant where the Commissioner must determine the taxpayer's profit under s. 25A(9), s. 25A (10)(b) being inapplicable. The deeming is only for the purposes of s. 26AAA, and could be relevant only if there is another operation of s. 26AAA arising from B's sale of his property within 12 months.

3.123 Paragraph (b) of s. 25A(10), it has been noted, has an operation limited by the condition that the transferor (X in the chart) has actually acquired the property for the purpose of profit-making by sale. Where para. (b) is not applicable, the calculation of profit on sale by a taxpayer who is deemed to have acquired for the purpose of profit-making by sale will be made by the Commissioner under the general provision in s. 25A(9). Presumably, the Commissioner will not consider it appropriate to allow as
a cost the value of the property taken by the taxpayer in the transfer to him in the prescribed manner. To allow that value as a cost would be to defeat a principal purpose of the enactment of subs. (5) of s. 25A. Yet a refusal to allow the value as a cost would be to depart from the general principle in *Bernard Elsey Pty Ltd* (1969) 121 C.L.R. 119, *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 and the principle asserted by Gibbs J. in *Curran* (1974) 131 C.L.R. 409.

3.124 The policy the Commissioner will assert is that so much of the increase in value that has not been taxed to the transferor (X in the chart) should be brought to tax on A's sale of the property. If the increase in value had been brought to tax on X's transfer in the prescribed manner, A is entitled to be allowed a cost of the value of the property at the time of the transfer to him. Such a policy is reflected in the words of the definition of a transfer in the prescribed manner in subs. (11) of s. 25A. A transfer in the prescribed manner does not include a transfer by way of distribution of property of a private company or private trust estate to the transferee in his capacity as a shareholder in the company or a beneficiary of the trust estate, if the property transferred is excepted property defined in subs. (12). The items of expected property are trading stock, and plant or articles within the meaning of s. 54 purchased for use for the purpose of producing assessable income. In regard to these instances of excepted property there are provisions in s. 36 and s. 59 whereby the Commissioner may tax the transferor in a way that reflects the increase in value.

3.125 The Commissioner must find a further policy when the question is whether he should bring to the computation of the profit the whole of the proceeds of sale by the taxpayer (A in the chart). Where the taxpayer is deemed to have acquired for profit-making by sale, but did not actually acquire for that purpose, there is room to argue that the policy of the new provisions is to bring to the calculation of profit only so much of the proceeds as will ensure that the profit that is income of A will include so much of the increase in value of the property in the hands of X as has not been brought to tax on the transfer by X to A. It may be expected, however, that the Commissioner will adopt as a further policy that a person who takes under a transfer in the prescribed manner ought to be taxed on any increase in value of the property during the time he holds the property. There may be some justification for such a policy where transferor and transferee (X and A in the chart) are persons who share income. It is hard to see the justification where they are not. None the less the Commissioner may claim that the policy he asserts is reflected in the specific provisions of s. 25A(10)(b) which do not contemplate any adjustment to the amount received by the transferee when he sells, such as would limit the amount...
taxed to him to the amount of the increase in value in the hands of the transferor that has not been taxed to the transferor.

3.126 The determination by the Commissioner of a profit on sale will need to be made though the sale by taxpayer A is made in the prescribed manner, that is, in a non-arm's length transaction for a consideration less than the value of the property. In such circumstances there is unlikely to be any question of the Commissioner excluding some of the proceeds of sale from the calculation of the profit, though in theory the issues that have been canvassed in previous paragraphs again arise.

3.127 Whether or not the sale by taxpayer A is in the prescribed manner, there is the prospect of the allowance of a loss by the Commissioner under s. 52(2). There will be no loss allowable under s. 52(1)—it is precluded by s. 52(3). In theory, a loss may be allowed by the Commissioner though the sale was in the prescribed manner, so that the proceeds of sale are less than the value of the property sold. Section 52(5)(a) does not preclude the allowance of the loss in these circumstances—it is confined to an allowance of a loss under s. 52(1). The Commissioner is however unlikely to allow the loss. If he does, and s. 25A(10)(b) is applicable, there will be problems in the operation of that paragraph when B later sells the property. An appropriate determination of profit would need to add to the proceeds of sale by B the amount of the loss allowed to A. On the other hand, if s. 25A(10)(b) is not applicable—the view expressed above is that it is not—and the Commissioner acts only under s. 25A(9), it would be inappropriate, if he has not allowed A a loss, to calculate the profit derived by B by reference to the actual price paid by B to A.

3.128 Section 52(2)(c) directs the Commissioner to have regard in all circumstances to the price paid by the person from whom the taxpayer acquired the property. In Chart A where B is the taxpayer, this would be the price paid by A to X. There is in the result some want of coherence with s. 25A(10)(b) which, in calculating a profit made by B, requires reference to the price paid by A only when A has actually acquired for the purpose of profit-making by sale. One is again left with an uneasy feeling that the circuitry of s. 25A and s. 52 is defective, and that both loss and profit depend on an unpredictable manual interference by the Commissioner.

3.129 Paragraph (b) of s. 52(2) imposes a limitation on the Commissioner's power to allow a loss. The limitation is that he must be satisfied that the property has not been held or used by the taxpayer in a manner inconsistent with the purpose of profit-making by sale that s. 25A(5) deems the taxpayer to have. The policy of para. (b) has some kinship with the policy reflected in s. 25A(10)(b)(ii). The policy of the latter provision is that a
taxpayer should not be taxed on a profit attributable to improvements he may have effected to property unrelated to any profit purpose. That provision will also allow the Commissioner in effect to deny an element of loss in relation to the improvements. He would do this by setting the amount that would in his opinion have been the consideration received or receivable if the taxpayer had not incurred the expenditure, at a figure less than the amount of the expenditure. Paragraph (b) of s. 52(2) does not attempt any refinement in its operation. If there has been any use of the property which is inconsistent with the deemed purpose, the taxpayer is simply denied a loss, and this notwithstanding that at least some of his loss would none the less have been incurred if he had not made any inconsistent use of the property.

Disposition of an interest in property acquired for the purpose of profit-making by sale or a disposition of property in which an interest acquired for the purpose of profit-making by sale has merged: Transactions (III) and (IV)

3.130 The relevant provisions are subss (6), (8), (9), (10)(c), (11) and (12) of s. 25A, and subss (2), (3), (4) and (5)(a) of s. 52. They may be described as the identity doctrine amendments, and the identity doctrine and N. F. Williams amendments.

3.131 Transactions (III) and (IV) may be considered together. They are dealt with in Chart B. The background of the provisions dealing with these transactions is a development, in the cases interpreting the first limb of s. 26(a), of a doctrine that required an identity between the property acquired and the property sold. If there was no such identity, the first limb of s. 26(a) could have no operation.

3.132 The first indications of an identity doctrine appear in the judgments of Windeyer J. at first instance in White (1968) 120 C.L.R. 191 at 208 and in the joint judgment of Taylor and Owen JJ. in the Full Court (at 218). Taylor and Owen JJ. said:

“The first of [the contentions] to which we shall direct our attention is that the first limb of s. 26(a) applies to the case. . . . But there are difficulties in the way of the [Commissioner] succeeding on this contention not the least of which is that even if it was the purpose of, or a purpose of, the taxpayer in purchasing the land to sell the standing timber for his own profit, such a purpose might well be thought not sufficient to bring the matter within the first limb.”

3.133 The identity doctrine takes on more definition in the judgment of Windeyer J. in McClelland (1969) 118 C.L.R. 353 at 359:

“The taxpayer had, by the bounty of the testator, acquired an undivided share in the land. This was given to her. It was not acquired by her for the purpose of profit-
making. She acquired the other half share by purchase. She did this so that she might as owner of the entirety sell it to her own advantage. She bought an undivided share. She sold an entirety, portion 5. The first part of s. 26(a), that is the part quoted above, applies to a transaction whereby a taxpayer sells any property he acquired for the purpose of sale. It applies whether he sells that property as a whole or in parts, and whether when he sells he sells to one buyer or to several buyers as joint tenants or tenants in common. But, as I read it, it does not apply when what is sold is essentially different in kind from the thing acquired. It would apply in the case of a taxpayer A who, by purchasing from two tenants in common, B and C, the share of each, acquired Blackacre for the purpose of thereafter selling it at a profit. There the thing acquired for the profit-making purpose was Blackacre. That is not this case. I cannot accept the proposition, put for the Commissioner, that when Mrs McClelland sold portion 5 she sold two separate shares in it, hers and her brother's. She did not. She was not selling separate shares. The shares had disappeared into a unity. She sold an entirety.”

A number of situations are identified in the passage quoted as situations to which s. 26 (a) first limb did apply, the identity requirement being satisfied. There is identity where the taxpayer acquires property and sells part of it to another, for example on a subdivision of the property. There may however be a difference between selling the whole undivided interest in a part of property and selling a part of the undivided interest in the whole of the property. An example of the latter would involve a taxpayer who acquires property and sells a half undivided interest as tenant in common to another. The requirement of identity is satisfied where a taxpayer acquires the undivided half interest of two tenants in common, in each case for the purpose of profit-making by sale, and then sells the whole interest in the property. The requirement of identity in this case is satisfied even though there has been a merger of the undivided interests. The requirement of identity will not however be met where a taxpayer holds an undivided half interest as tenant in common, acquired in circumstances where there was no purpose of profit-making by sale, and then acquires the other undivided half interest for the purpose of profit-making by sale. Thereafter he sells the whole interest in the property. The doctrine requiring identity received the support of Barwick C.J. in *A. L. Hamblin Equipment Pty Ltd* (1974) 131 C.L.R. 570 at 575, where he treated it as not satisfied where the hirer under a hire-purchase agreement has an interest not acquired for the purpose of profit-making by sale, and thereafter acquires the remaining interest in the property from the owner for the purpose of profit-making by sale. He also treated it as not satisfied where a lessee has an interest not acquired for profit-making by sale, and subsequently acquires the reversion for the purpose of profit-making by sale. Mason J. agreed with Barwick C.J. on statements of the identity doctrine, disagreeing only on the view to be taken of the facts. Mason J. did however offer a statement in relation to the identity doctrine in which neither Windeyer J. nor Barwick C.J. might have agreed. He considered that the requirement of identity is satisfied where property is acquired for the purpose of profit-making by sale and newly created strata titles to parts of the property are sold.

3.134 Section 25A(6) is directed against the defeat of the operation of the first limb of s. 25A that the requirements of identity might involve. It will operate within its terms to deem the taxpayer (A in Chart B) to have acquired the property he sells for the purpose of profit-making by sale, and
will thus satisfy the identity requirement in a number of circumstances where it would otherwise defeat the operation of the first limb: The consequence that the Commissioner has a function to determine under s. 25A(9) the profit arising from the sale is attracted. In this regard the provisions of s. 25A(10)(c) will be relevant. Section 25A(6) may however have a wider operation. Its terms may cover circumstances in which the identity requirement is satisfied. It will none the less bring about a deemed acquisition by the taxpayer of the property sold for the purpose of profit-making by sale, and the Commissioner's function to determine the profit will be attracted. In this aspect, s. 25A(6) does not prevent the defeat of the first limb of s. 25A(1). No defeat is threatened. It makes a significant change however in the operation of the first limb, so as to substitute for principles of profit determination a function in the Commissioner, a function whose policy will not, in this instance, be readily apparent.

3.135 The scope of s. 25A(6) in preventing the defeat of the first limb might first be considered. It may be thought that s. 25A(6) will not operate in the circumstances of McClelland, as they are described by Windeyer J. in the quotation in [3.133] above, if there is no merger of the brother's interest with the already subsisting interest of the taxpayer. The terms of s. 25A(6), in para. (b)(ii), require that the property sold should be property “in which was merged an interest in property, being an interest acquired by the taxpayer for the purpose of profit-making by sale”. It may be, of course, that where there is no merger the identity requirement is satisfied. None of the statements of the doctrine is definitive in this respect. And there is a question of how a merger can be prevented. Section 10 of the Conveyancing Act 1919 (N.S.W.) provides that “there shall not . . . be held or deemed to be any merger by operation of law only of any estate, the beneficial interest in which would not be deemed to be merged or extinguished in equity . . . ”. The Equity Court will have regard to the intention of the parties in deciding whether a merger has occurred. The possibility is thus open that a provision in the contract by which a tenancy in common is acquired, or a provision in the conveyance of the interest, may be sufficient to prevent a merger and exclude the operation of s. 25A (6). This is to assume that the word “merger” in the provision will receive a technical construction, so that the word will be given the meaning it has as a term of legal art.

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for the purpose of profit-prescribed manner: s. 25A(11). making by sale and Profit is income, transfers an interest in that Commissioner determines property, or, has acquired profit under s. 25A(9). S. 25A an interest in property for (10)(c) is also applicable if the purpose of profit-there is property to which the making by sale and the transferred property is related interest is merged in the that was not actually acquired property he transfers. He is by A for the purpose of profit-deemed to have acquired making by sale. Loss is the interest transferred for allowable: s. 52(1) qualified by the purpose of profit-s. 52(4). making by sale: s. 25A(6).

OR

(ii) Sells in the prescribed Deemed to (i) Sells other than in the manner: s. 25A(11). Profit is have prescribed manner: s. 25A income. Commissioner acquired all (11). Profit is income. determines profit under s. 25A the property Calculation under s. 25A (9). S. 25A(10)(c) is also acquired for (9). S. 25A(10)(c) is also applicable if there is property the purpose applicable if there is to which the transferred of profit-property to which the property is related that was not making by transferred property is actually acquired by A for the sale: s. 25A related that was not purpose of profit-making by (8). actual acquired by B or another person for the purpose of profit-making by sale. Loss is allowable: s. 52(5)(a).

OR

(ii) Sells in the prescribed Deemed to manner: s. 25A(11) Profit have is income. Calculation acquired all under s. 25A(9). S. 25A the property (10)(c) is also applicable if acquired for there is property to which the purpose the transferred property is of profit-related that was not making by actually acquired by B or sale: s. 25A by another person for the purpose of profit-making by sale. Loss is allowable: s. 52(2) and (3).

*If A does not sell to B, or B does not sell to C, but transfers in the prescribed manner by way of gift inter vivos, or as a private company or private trust estate making a distribution to a shareholder or beneficiary, there will be no profit or loss by A or B. However, B or C will be deemed to acquire for profit-making by sale: s. 25A(8) and (5).

3.136 There is a number of circumstances where s. 25A(6) will operate though the circumstances are such that the requirement of identity is satisfied. In these circumstances the provision brings about a change in the operation of the first limb of s. 25A(1), by letting in a Commissioner's function to determine the profit from the transaction. It is enough that the
property sold was “an interest in property, being property acquired by the
taxpayer for the purpose of profit-making by sale”. The word “interest” in
this context may be given a meaning that is wide enough to cover the sale
of the whole interest in part of property acquired for profit-making by sale.
It would thus cover the acquisition of property and sales of it in
subdivision. And it would cover the acquisition of property and sales of
newly created strata titles to parts of the property, a circumstance where, in
the view of Mason J. in Moruben Gardens Pty Ltd (1972) 46 A.L.J.R. 559,
the requirement of identity is satisfied.
3.137 In McClelland (1969) 118 C.L.R. 353 Windeyer J. expressed the
view that the identity requirement is satisfied where a taxpayer purchases
the interests of two tenants in common in property and thereafter sells the
property. Those circumstances are none the less covered by the words of s.
25A(6)(b)(ii), which will apply notwithstanding that both of the interests
which merge the one in the other were acquired for the purpose of profit-
making by sale.
3.138 The consequences of a deeming under s. 25A(6) are the letting in of
the Commissioner's power to determine the profit under s. 25A(9) on the
sale of the property, guided by the direction in s. 25A(10)(c), and the
Commissioner's power to adjust the amount of a loss under s. 52(4) in the
situation where the deemed acquisition for the purpose of profit-making by
sale depends on the operation of s. 25A(6)(b)(ii)—the merger situation
there described.
3.139 The direction given by s. 25A(10)(c) is presumably intended to
ensure that the Commissioner will exclude from the profit brought to tax,
so much as may be regarded as arising from that interest in the property
sold that was not actually acquired for the purpose of profit-making by
sale. The direction is framed in the vaguest of terms, but the suggested
intention is at least a rational explanation. In Chart B the determination of
the profit by the Commissioner on the sale by A, will, in a s. 25A(6)(ii)
situation where only one of the interests that have merged was acquired for
the purpose of profit-making by sale, exclude so much as is attributable to
the interest that was not acquired by A for the purpose of profit-making by
sale. Thus in the circumstances of McClelland, assuming that the taxpayer
does not acquire the inherited interest for the purpose of profit-making by
sale, profit on the sale of that interest when merged with the interest
acquired for profit-making by sale should have excluded from it the
element that is attributable to the inherited interest.
3.140 A method of exclusion would be to apportion the proceeds of sale
between the two interests by reference to the values of the two interests
before their merger. A method that would apportion by reference to the
costs of the two interests would have an unfair operation. Any method adopted by the Commissioner is likely to seek to bring to tax the element of increase in value of the interest actually acquired for profit-making by sale, that arises on its merger with the other interest. A method that seeks to exclude that element of increase in value would need to identify so much of the proceeds of sale as would have been the proceeds if only an interest equivalent to the interest acquired for profit-making by sale had been sold. That would involve an exercise in reconstruction that might be thought to be outside the Commissioner's function. It is of course an exercise in reconstruction on which he would not easily be persuaded to engage.

3.141 One might expect that the method the Commissioner adopts for separating out and excluding an element of profit attributable to the interest not acquired for profit-making by sale, will also be adopted in separating out the element of any loss that is attributable to that interest when the Commissioner exercises his function under s. 52(4).

3.142 Where the sale in Chart B by A to B is made in the prescribed manner, problems of the method of profit determination to give effect to the direction in s. 25A(10)(c) arise, but all problems in regard to the method of loss determination are excluded by s. 52(5)(a): no loss is allowable.

3.143 Such a sale in the prescribed manner will attract the operation of s. 25A(8), whose purpose parallels the purpose of s. 25A(5). The person who takes under the sale in the prescribed manner (B in Chart B) is deemed to have acquired the property for the purpose of profit-making by sale. Where the property is the result of a merger with other property, the deeming extends to the whole of the property acquired. If B sells to C, the profit will be determined by the Commissioner in accordance with the direction in s. 25A(10)(c). The problems involved in finding a method of determining profit that will fairly reflect that direction, considered in [3.140] and [3.141] above, will again arise. And there will be problems of a kind considered in dealing with Transaction (II) in [3.115] and [3.125] above, as to the extent of the profit that it is the policy of the Act to include in B's income. The question is whether the policy is only to include the residue of the profit that would have been made by A had he not sold in the prescribed manner. In that regard it may be appropriate to distinguish the case where B has taken only with a deemed purpose of profit-making by sale, from a case where he has an actual purpose of profit-making by sale.

3.144 If B has taken with an actual purpose of profit-making by sale there will not be any room for the operation of the direction in s. 25A(10)(c): all the property sold will be property that has been acquired by some person for the purpose of profit-making by sale. Within the terms of s. 25A(10)(c)
all the “property consists of, or is attributable to, the related property”. And there will be no room for the operation of s. 52(4) in determining a loss.

3.145 Section 25A(8) parallels the purpose of s. 25A(5), but there is no attempt in s. 25A(10)(b) to extend that paragraph to the determination of a profit on the sale of a property deemed by s. 25A(8) to have been acquired for profit-making by sale. No doubt the draftsman was glad to be relieved of the need to design the circuitry that would have been necessary.

3.146 Where the question is one of the allowing of a loss, s. 52(2) is applicable and in this respect the consequences of s. 25A(5) and (8) are in parallel. Thus, curiously it may be thought, a loss may be allowable to B on his sale in the prescribed manner to C, though a loss on a sale in the prescribed manner was not available to A. Section 52(5)(a) there denied the operation of s. 52(1), and s. 52(2) had no application.

A taxpayer actually acquires shares in a company for the purpose of profit-making by sale, or is deemed by the operation of any provisions of s. 25A to have acquired shares for that purpose, and the company makes a bonus issue or a rights issue to the taxpayer: Transaction (V)

3.147 The transaction, extended so as to indicate the consequences of sales of the bonus shares or the rights, is outlined in Chart C. The key provisions are s. 25A(4) and s. 25A(10)(d) and (e). They might be described as the Miranda amendments.

3.148 The background of these provisions is the decision of Rath J. in Miranda (1976) 76 A.T.C. 4180. Bonus shares and rights to shares issued by a company are items of property distinct from the shares in regard to which they are issued. A taxpayer who sells bonus shares or rights issued to him in respect of shares he has acquired, does not sell the original shares. It was therefore irrelevant, in determining the operation of s. 26(a) on the sale of the bonus shares or rights, that the original shares may have been acquired for the purpose of profit-making by sale. The bonus shares and rights are not in themselves property acquired for the purpose of profit-making by sale. There was no purposive acquisition, at least when the taxpayer who receives the shares or rights did not exercise any control of the directors of the company that made the issue.

3.149 The effect of s. 25A(4) is to deem bonus shares and rights issued by a company to a taxpayer who acquired the shares to which the issues relate for the purpose of profit-making by sale, to have themselves been acquired by the taxpayer for the purpose of profit-making by sale. The deeming will give the Commissioner power to determine how much of the proceeds of sale should be treated as a profit arising from the sale of the bonus shares or rights. Where bonus shares are involved, s. 25A(10)(e) provides that the
cost to the taxpayer is to be ascertained in accordance with s. 6BA. Where
rights are involved, s. 25A(10)(d) provides that the rights shall be deemed
to have been acquired by the taxpayer at no cost. Section 25A(4) is
confined in its operation to bonus and rights issues, and in the latter respect
to rights issued “by reason that the taxpayer was the owner of the
shares” (s. 25A(4)(b)(ii)). It does not apply to rights issued to a taxpayer by
reason of his ownership of options, debentures or securities.

3.150 Section 25A(10)(e) specifically adopts s. 6BA in the determination
of the cost of the bonus shares. Section 6BA will have the effect of
transferring some of the cost of the original shares to the bonus shares, and
will deny that any part of the moneys paid up on the bonus shares in the
process of their issue is a cost to the taxpayer of the bonus shares. The
denyng of the cost will operate save where the moneys paid up have been or
will be included in the assessable income of the taxpayer, and the
taxpayer is not a resident treat the acquisition of the options as an
acquisition at no cost notwithstanding that the taxpayer has paid a
substantial sum on the exercise of the rights, in acquiring the options. At
the same time it might be observed that the issue of rights to options
requiring only a minimal payment on the exercise of the rights will be a
way of defeating the purpose of s. 25A(4). There is of course the prospect
that the options will in fact be purposively acquired and a profit company:
s. 6BA(2) and (4). Section 6BA overcomes Curran (1974) 131 C.L.R. 409,
in its possible application to bonus shares that are deemed to have been
acquired for profit-making by sale.

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A acquires or is deemed (i) Sells other than in the to have acquired shares prescribed manner (s. 25A(11)), for the purpose of profit- Profit is income. making by sale, and then Commissioner's determination receives Bonus Shares or under s. 25A(10). Cost: Bonus Rights. The Bonus Shares: s. 6BA. Rights: nil cost, Shares or Rights are (s. 25A(10)(e) and (d)). Loss deemed to have been (could arise only re Bonus acquired for the purpose Shares) is allowable: s. 52(1).

of profit-making by sale:
s. 25A(4).

OR
(ii) Sells in the prescribed Deemed to (i) Sells other than the manner (s. 25A(11)).* Profit is have prescribed manner (s. 25A income. Commissioner's acquired for (11)). Profit is income. determination under s. 25A(9), profit- Calculation by s. 25A(9). S. Cost: Bonus Shares: s. 6BA. making by 25A(10)(b) has no Rights: nil cost (s. 25A(10)(e) sale: s. 25A application. Loss allowable:
If A does not sell to B, or B does not sell to C, but transfers in the prescribed manner by way of gift inter vivos, or as a private company or private trust estate making a distribution to a shareholder or beneficiary, there will be no profit or loss by A or B. However, B or C will be deemed to acquire for profit-making by sale: s. 25A(5).

3.151 A suggestion might be raised that the operation of s. 25A(4) can be avoided if the bonus issue is not made “in satisfaction of a dividend . . . payable to the taxpayer in respect of the shares”—the words of s. 25A(4). But the issue of bonus shares without any expressed intermediate stage of dividend and application of that dividend in paying up the shares, raises the prospect that the shareholder has received a dividend on which he is subject to tax. Indeed even if the bonus shares are expressed to be in satisfaction of a dividend, they will only escape tax as a dividend if the dividend is wholly and exclusively out of profits arising from the sale or revaluation of assets not acquired for the purpose of resale at a profit (s. 44 (2)).

3.152 An attempt to make a bonus issue without a dividend in satisfaction of which the shares are issued may involve one of two consequences. The bonus issue will be construed as the declaration of a dividend to be applied in paying up the bonus shares. In which event s. 25A(4) has not been avoided, and the shareholder may find that he has both acquired a taxable dividend and is deemed to have acquired for the purpose of profit-making by sale. The construction may not extend to treating the dividend as wholly and exclusively out of capital profits. The other possible consequence is that the shareholder may be treated as holding shares that are subject to call of the amount to which they are expressed to be paid up. In the latter event, s. 25A(4) has been avoided, but there is a prospect that in accepting a liability to make payment for the shares the taxpayer will be held to have acquired for the purpose of profit-making by sale.

3.153 Rights issued in respect of the shares acquired for profit-making by sale will be deemed to have been issued at nil cost: s. 25A(10)(d). There is
no provision that will transfer cost from the original shares to the rights in
the way in which some part of the cost of the original shares will be
transferred by s. 6BA to bonus shares. Section 52A is inapplicable. It
applies only when shares are acquired as trading stock, or in the carrying
on or carrying out of a profit-making undertaking or scheme. In the result
the effect of a rights issue will continue to create an opportunity for the
taxpayer to sell the original shares at a loss for tax purposes, though the fall
in value of the original shares is effectively recouped to the taxpayer by the
rights issue. There is a question whether s. 25A(4) extends to options to
acquire shares issued by a company to the owner of shares, following the
exercise by him of rights to acquire options issued to him by the company.
Presumably it does not. The issue to the taxpayer of the options is not made
to the taxpayer by reason that has was the owner of the shares but by
reason that he was the owner of the rights. If the subsection did extend to
the options, s. 25A(10)(d) would have rogue operation. It would treat the
acquisition of the options as an acquisition at no cost notwithstanding that
the taxpayer has paid a substantial sum on the exercise of the rights, in
acquiring the options. At the same time it might be observed that the issue
of rights to options requiring only a minimal payment on the exercise of
the rights will be a way of defeating the purpose of s. 25A(4). There is of
course the prospect that the options will in fact be purposively acquired
and a profit on the sale of the options will be income. But in the
determination of that profit the value of the rights at the time of exercise
will be a cost of the options.

3.154 The power in the Commissioner to determine a profit on the sale of
the bonus shares, a power given him by s. 25A(9), is qualified by s. 25A
(10)(e). The Commissioner's power is confined to the exercise of the
functions given him by s. 6BA. Equally the Commissioner's power to
determine a profit on the sale of the rights issued to the taxpayer in respect
of the original shares is confined by s. 25A(10)(d). In effect he has no
function to perform. The gross proceeds of sale of the rights will be the
profit that is income.

3.155 The fact that the sale of the bonus shares is made in the prescribed
manner will not give the Commissioner any special power to determine the
profit. A power to determine how much of the proceeds of sale it is
appropriate to treat as a profit, is not a power to increase the proceeds of
sale so that they represent a market price. A sale of the bonus shares in the
prescribed manner may not however give rise to a loss. Section 52(5)(a)
precludes the allowance of a loss.

3.156 A sale of the bonus shares or of the rights in the prescribed manner
(by A to B in Chart C) will however give rise to a deeming that B has
acquired for the purpose of profit-making by sale. Section 25A(5) will give rise to this deeming, though A did not actually acquire the bonus shares or rights for profit-making by sale. Problems of determining the profit that is income on sales by B have already been explored in other contexts. A curiosity already noted is evident also here. A sale by A in the prescribed manner cannot give rise to a loss, but a sale by B may do so.

3.157 The consequences of s. 25A(4) and s. 25A(10)(d) if the taxpayer does not sell the rights, but exercises them, and subsequently sells the shares, call for some examination. The sale of the shares is not a sale of the rights, and it may be doubted that s. 25A(6) will require that the shares be deemed to have been acquired for the purpose of profit-making by sale. The shares are not property in which the rights have merged.

3.158 The acquisition of the shares might be seen as a two stage acquisition — the acquisition of the rights and the exercise of the rights. But tax consequences on the sale of the shares will require, in the exercise of the rights, at least an actual purpose of acquisition for profit-making by sale. And there will be a question whether the deemed purpose under s. 25A(4) in relation to the rights may be combined with an actual purpose on exercise, so as to give an actual purpose of profit-making by sale in the acquisition of the shares. If the deemed and the actual can be combined in this way there will be a further question as to the cost of the rights as an element in the cost of the shares. The deeming by s. 25A(10)(d) that rights have a nil cost does not appear to have any application. The deeming is expressed to be for “the purposes of the application of subs. (9)”, which is concerned with the determination of the profit on the sale of property that is deemed to have been acquired by the taxpayer for the purpose of profit-making by sale by virtue of any of the preceding provisions of the section. The shares acquired in the exercise of the rights are not deemed to have been so acquired. In the result the rights will have a cost equal to their value at the time of their exercise.

3.159 If the acquisition of the shares is seen as a one-step acquisition in the exercise of the rights, as in Executor Trustee & Agency Co. of S.A. Ltd (Bristowe's case) (1962) 36 A.L.J.R. 271, it is even clearer that s. 25A(10) (d) can have no application. The cost of the shares will include the value of the rights at the time of their exercise.

Section 26AAA: Gains from the Sale of Property within 12 months of Purchase

3.160 Section 26AAA was added to the Assessment Act in 1973. Its effect is to extend the meaning of income in the Act to include gains which
would not be income within the ordinary usage meaning of the word or s. 25A(1). Where purchase and sale of property are within a period of 12 months a resulting gain by a taxpayer will be income under s. 26AAA whether or not s. 25A is also attracted and, it seems, whether or not his actions also amount to an isolated business venture. Where, however, “the property [sold] was included in the assets of a business carried on by [a] taxpayer and, as a result of the sale, an amount will be included in the assessable income of the taxpayer under a provision of the [Assessment Act] other than [s. 26AAA]”, s. 26AAA has no operation to make any gain on the sale income of the taxpayer. This is the effect of s. 26AAA(5)(a). Presumably the reference to “business carried on” is a reference to continuing business operations.

3.161 Attention is directed in [3.122] to possible consequences of the concurrent operations of s. 26AAA and the first limb of s. 25A(1).

3.162 The effect of Mullins (1981) 81 A.T.C. 4643 is that a balancing charge arising, on the sale of land within 12 months of purchase, as a result of depreciation allowed in respect of fences on the land, will exclude the operation of s. 26AAA if the land is an asset of a business carried on by the taxpayer. There may in the result be the exclusion from income of a substantial sum at the price of what may be a relatively small balancing charge under s. 59. The exclusion is by the operation of s. 26AAA(5)(a), and not s. 26AAA(5)(b). The latter provision excludes the operation of s. 26AAA if “section 54 applied in relation to the property and, as a result of the sale, section 59 applies in relation to the property”. The relevant property is the land, and not the fixture that is the item of depreciable property.

3.163 Another limitation on the operation of s. 26AAA is provided for in s. 26AAA(5)(c) where the sale is a sale of property used by the taxpayer as a sole or principal residence, or is a sale of shares which give a right of occupancy of a flat or home unit used by the taxpayer as his sole or principal residence. Section 26AAA will not apply if the sale took place as a result of a change in the place of employment, or place of business of the taxpayer. Section 26AAA(6) qualifies the limitation where only part of the land sold is occupied by a dwelling used by the taxpayer as a sole or principal residence.

3.164 The operative provision of s. 26AAA is s. 26AAA(2). The words of s. 26AAA(2) have meanings extended by the interpretations in subs. (1) and by the deeming provisions of subss (3), (4) and (7). The words of s. 26AAA and those extensions and deeming provisions do not appear to preclude the application to s. 26AAA of the identity requirement that was applicable to the first limb of s. 26(a). Section 26AAA(2), by its terms,
covers a purchase of property and the sale of an interest in that property, but that was probably not a situation affected by the identity requirement of s. 26(a). The identity requirement, as it operated in *McClelland* and *Hamblin*, would appear to be applicable to s. 26AAA. Section 26AAA(1)(a) gives an extended interpretation to “property”, but does not seek to deal with an identity requirement.

3.165 Where a bonus issue of shares is made attendant upon original shares that were purchased by the taxpayer within 12 months before the bonus issue, the bonus shares are deemed to have been purchased by the taxpayer at the time he purchased the original shares. Subsection (7) presumably deems the fact of purchase to have occurred, and fixes the time of that purchase. There are two deemings involved. The bonus shares are deemed to have been purchased, where they are issued within 12 months of the purchase of the original shares, and they are deemed to have been purchased at the time when the taxpayer purchased the shares in respect of which the dividend was payable. A bonus issue is presumably not purchased in other circumstances. An inference may be drawn from paras (d) and (e) of s. 26AAA(1) that the acquisition of property that comes into existence only as it is acquired is not a purchase of that property: the notion of purchase is confined, in the absence of some deeming, to an acquisition of property that existed before the purchase. It is possible that a bonus issue is a purchase as “the acquisition of . . . share[s] by way of a subscription of capital” which, by s. 26AAA(1)(d), is deemed to be a purchase. The subscription of capital, it might be argued, is the notional dividend involved in the bonus issue which is applied by the company in the paying up of the shares. If s. 26AAA(1)(d) does not supply the element of purchase, bonus shares issued more than 12 months from the time of purchase of the shares in respect of which they were issued cannot attract the operation of s. 26AAA. Where s. 26AAA does operate the determination of the cost of the bonus shares will be made by the Commissioner under s. 6BA(3), unless the operation of that provision is excluded by s. 6BA(4). It may be excluded, in the case of a taxpayer other than a company, if the bonus shares themselves involve a derivation of income, s. 44(2) being inapplicable. In which event, the cost for purposes of determination of a s. 26AAA profit is not expressly dealt with. On general principle the cost would be, in these circumstances, the amount of the dividend applied in paying up the bonus shares—the amount credited within the definition of “dividend” in s. 6, that is assessable income under s. 44(1). The general principle of tax accounting is that an item of property that is income arising in some process of derivation of income must be given a cost of the amount in which it is income. There will otherwise be
double taxation of an income item.

3.166 A bonus issue attendant upon shares which were themselves bonus shares does not appear to be covered by s. 26AAA(7). Section 26AAA(7) does not in its terms contemplate successive applications so as to deem the bonus shares to be shares purchased for purposes of para. (a). The second bonus issue would thus escape the operation of s. 26AAA, unless the interpretation provision in s. 26AAA(1)(d) is considered to be applicable. The application of subs. (1)(d) would require the characterisation of a bonus issue as “the acquisition of a share by way of a subscription of capital”.

3.167 A rights issue is not made in any circumstances a purchase of the rights.

3.168 Section 26AAA(1)(f) substantially extends the operation of s. 26AAA in a wide range of situations. A transfer by way of gift, either wholly so, or partly so because of inadequacy of consideration, is a deemed sale by the transferor and a deemed purchase by the transferee. There is a question of the cost to be allowed in determining the amount of the profit which is income of the purchaser if he sells within 12 months. Were it not for s. 26AAA(4) the principle asserted in [3.39]–[3.41] above in relation to the first limb of s. 25A(1) would be appropriate: the transferee would be deemed to have purchased at market value at the time of acquisition. The deeming provided for in the concluding words of s. 26AAA(4)(c) presents a difficulty. The need for a deeming that the donee has purchased at market value in a case where the donor is subject to the operation of s. 26AAA(4) may suggest that a donee in other circumstances is not entitled to market value as his cost. An inference of this kind would be unfortunate.

3.169 In the last paragraph it was assumed that s. 26AAA(1)(f) deems that there is a purchase where money is paid for property but the amount is less than the market value of that property. It could be said that in these circumstances property is “transferred . . . in exchange for other property”. Such a situation may in any case be a sale and purchase without the assistance of any deeming. Whether there is a deemed or actual purchase, the principle supported in [3.39]–[3.41] above should apply.

3.170 There are situations where the application of s. 26AAA(1)(f) may be considered doubtful. It may be asked whether the transfer of property to a beneficiary under a will is a transfer “without consideration”. It may be asked whether the transfer of property in specie to a shareholder by way of dividend, or in the liquidation of a company, is a transfer “without consideration”. In relation to both questions the reasoning in Archibald Howie Pty Ltd v. Commissioner of Stamp Duties (N.S.W.) (1948) 77 C.L.R. 143 would suggest a negative answer. If however, these situations are held
to be within subs. (1)(f), the question of cost for purposes of computing the profit which is income of the transferee will be so much the more pervasive. It would be argued that the cost is the market value of the item at the time of its receipt by the transferee.

3.171 It will be recalled that there can be no profit which is income under the first limb of s. 25A(1) unless there is a sale, and under both limbs any profit which is income must be calculated by reference to actual proceeds so that there can be no profit which is income if property is given away or disposed of for a consideration less than cost. A gift therefore is a way of aborting a s. 25A(1) transaction, though the character of a transaction as a s. 25A(1) first limb transaction, will generally be transferred, by s. 25A(5), to the transaction in which the donee acquires the property. Section 26AAA, in subs. (4), includes a provision which deems a sale in circumstances where the Commissioner is satisfied that the parties were not dealing with one another at arm's length, to be a sale at a price which in the opinion of the Commissioner was the value of the property at the time of sale. Subsection (4) has a function akin to s. 36 in relation to trading stock disposed of otherwise than in the course of carrying on a business.

3.172 Section 26AAA(3) deems a purchase and sale to be within the 12 months period, though the sale is made outside that period, if the sale was made in pursuance of an option or agreement granted or entered into during that period. In this case, if s. 26AAA(4) is applicable, the value of the property sold is determined not at the time of sale but at the time of the option or agreement.

3.173 In [3.46] above attention was drawn to the implications of Hobart Bridge Co. Ltd (1951) 82 C.L.R. 372 in providing a way of escape from the operation of the first limb of s. 26(a). The provisions of subss (2) and (3) of s. 25A, in blocking off that way of escape, were considered in [3.85]–[3.102] above. The way of escape from s. 26(a) suggested by Hobart Bridge had its parallel in a way of escape from the operation of s. 26AAA which involved the purchase of property by a subsidiary company and the sale of shares in the holding company within 12 months of the purchase by the subsidiary. The taxpayer, in a typical set of circumstances, was the holding company of a subsidiary that had been formed to acquire shares in another company in a take-over bid. The subsidiary would acquire shares in the take-over target, not for the purpose of profit-making by sale but to hold them. If, however, the bid was unsuccessful, it would be anticipated that the taxpayer would sell its shares in the subsidiary at a profit reflecting an increase in value of the shares held by the subsidiary in the target company. That increase in value may have arisen from the pressure of another bid for shares in the target company made by the
ultimately successful bidder. The sale of shares by the taxpayer would be made within 12 months of the acquisition of shares by the subsidiary. But the subsidiary, now the subsidiary of the successful bidder, would continue to hold the shares it had acquired in the course of the earlier bid at least until 12 months had expired from the acquisition of those shares.

3.174 In 1982 subsections were added to s. 26AAA to prevent this way of escape. The relevant provisions are s. 26AAA(1)(h)-(m), (2A), (2B), (3A), (4)(a), (4)(c)(iii), (4)(c)(iv) and (10). At the same time provisions were added to prevent another way of escape from the operation of s. 26AAA. A company or trust holding property acquired within 12 months would make a distribution of that property to a shareholder or beneficiary. The distribution, it was considered, did not qualify as a sale despite the extended meaning given to the concept of sale by s. 26AAA(1)(f). The person taking in the distribution had not purchased the property, and could sell without attracting the operation of s. 26AAA. There would be no purposive acquisition to let in the operation of s. 26(a). The provisions directed to closing this way of escape are s. 26AAA (1)(h)-(m), (8), (9), (10) and (11).

3.175 The provisions directed against the way of escape suggested by Hobart Bridge have as their core s. 26AAA(2A). There are obvious parallels with the s. 25A(2) provisions considered in [3.85]–[3.102] above. The provisions now considered were in fact the model for s. 25A(2).

3.176 Section 26AAA(2A) is concerned with a sale of property that was acquired by a taxpayer more than 12 months before the sale. Where a sale relates to property that was acquired within 12 months of the sale, the relevant provision is s. 25AAA(2). That provision, it may be noted, has a narrower operation than s. 26AAA(2A) in one among other respects. It applies only where there has been a purchase. Section 26AAA(2A) requires only an acquisition. It is true that the meaning of purchase is extended for purposes of s. 26AAA(2) by a number of paragraphs of s. 26AAA(1). But the acquisition of an interest on entering into a partnership agreement, or the acquisition of an interest in a trust on the declaration of a trust, would not appear to be a purchase.

3.177 The property must be shares in a private company (defined in s. 26AAA(1)(j) in the manner of the definition in s. 25A(12)); an interest in a partnership; or an interest in a private trust estate (defined in s. 26AAA (1) (k) in the manner of the definition in s. 25A(12)). The private company, partnership or trustee of a private trust estate will in the discussion that follows be identified as the primary intermediary.

3.178 Where the property sold consists of shares in a primary intermediary that is a private company, or an interest in a primary intermediary that is a
trust estate, it is enough to attract the operation of s. 26AAA(2A) that the assets of the private company or private trust estate immediately before the sale by the taxpayer included property purchased within 12 months preceding the date of the sale by the taxpayer, that was not excepted property. This property will be identified as underlying property. It will be noted that there is no mention of underlying property held by a partnership primary intermediary (s. 26AAA(2A)(c)(i)). The inference may be that the sale of a taxpayer's interest in a partnership is to be seen as a sale of an interest in partnership assets, and s. 26AAA(2) will apply whenever the assets were acquired by the partnership less than 12 months before the sale of the interest in the partnership.

3.179 Where the property sold consisted of shares in a private company, an interest in a partnership or an interest in a private trust estate, the operation of s. 26AAA(2A) will be attracted if the company, partnership or trustee of the trust estate held an interest in underlying property at a lower level, through one or more interposed companies, partnerships or trusts, in property that was purchased by another private company, partnership or trustee of a private trust estate within a period of 12 months immediately preceding the sale by the taxpayer, and this underlying property was not excepted property (s. 26AAA(2A)(c)(ii)). It will be noted that in this instance s. 26AAA applies to a sale by the taxpayer of an interest in a partnership. It will also be noted that the tracing of property from the primary intermediary to what may be called a sub-intermediary may be made through a company or trust estate that is not a private company or private trust estate.

3.180 Whether the underlying property is held by a primary intermediary or a sub-intermediary, the operation of s. 26AAA(2A) is subject to a condition that immediately before the sale by the taxpayer of his shares in the private company, his interest in the partnership or his interest in the private trust estate, the value of the underlying property was not less than 75 per cent of the net worth of the company, partnership or trust estate that is the primary intermediary (s. 26AAA(2A)(d)).

3.181 The operation of s. 26AAA(2A) is to include in the assessable income of the taxpayer so much of the consideration received or receivable by the taxpayer in respect of the sale as, in the opinion of the Commissioner, may reasonably be attributed to the amount (if any) by which the value of the underlying property immediately before the sale exceeds the sum of the consideration given or agreed to be given for underlying property by the primary intermediary or sub-intermediary, and so much of any other expenditure incurred in relation to the underlying property as, in the opinion of the Commissioner, is appropriate in the
circumstances.

3.182 Excepted property is defined in s. 26AAA(1)(m). It includes trading stock of the company, partnership or trustee, and property acquired by the company, partnership or trustee for the purpose of profit-making by sale or carrying on or carrying out any profit-making undertaking or scheme. In both aspects what is included in excepted property is qualified by s. 26AAA(2B). The qualification is not easily interpreted. It applies in relation to underlying property at any level but only in its terms to underlying property held by a company or trust estate. It has no application in its terms to property held by a partnership. The assumption behind s. 26AAA(2A)(c)(i) thus reappears, though, it will have been noted, it is not an assumption of s. 26AAA(2A)(c)(ii). The assumption is that assets of a partnership are assets of the partners. The qualification by s. 26AAA(2B) comes into operation where the Commissioner is satisfied that the consideration received or receivable by the taxpayer, in respect of the sale of shares or interest in the primary intermediary, was substantially more than the consideration that might reasonably be expected to have been received or receivable by the taxpayer if the taxpayer and the person who purchased the shares or interest from the taxpayer had expected that the underlying property would be disposed of by the intermediary immediately after the sale for its market value, and an amount would have been included in the assessable income of the intermediary. The qualification behind the qualification would seem to be that in circumstances where it appears that it was not contemplated that there would be a sale of the trading stock or of the property acquired for profit-making by sale or carrying out of any profit-making undertaking or scheme, there is no reason for the qualification. The qualification is thus a partial anticipation of the provisions of s. 25A(2) introduced in 1984. Those provisions will cover the circumstances brought within s. 26AAA(2A) by the qualification to the exception, though they will of course have a wider operation. The operation of s. 26AAA(2A) requires that the acquisition by the intermediary should have been by way of purchase, and that the purchase should have been within 12 months before the sale of the shares or interest by the taxpayers. No such conditions apply to s. 25A(2). The operation of s. 26AAA(2A) requires that the shares or interest acquired by the taxpayer should have been acquired more than 12 months before the sale of the shares or interest. No such condition applies to s. 25A(2). The operation of s. 26AAA(2A) requires that the value of the underlying property should be not less than 75 per cent of the net worth of the primary intermediary. No such condition applies to s. 25A(2). Where both s. 26AAA(2A) and s. 25A(2) are applicable there will be income derived under two provisions, but
there will not be double taxation. The Commissioner may however rely on
the provision that will give rise to the greater amount of income. The
general principles in this regard are considered in [12.220]ff. below.

3.183 The determination of the amount of assessable income under s.
26AAA(2A) requires the exercise of a function by the Commissioner to
determine how much of the consideration received or receivable on the sale
by the taxpayer of his shares or interest, is attributable to the increase in
value of the underlying property over the amount of the consideration
given or agreed to be given for the underlying property. The effect is to
treat as income derived by the taxpayer on the sale of his shares or interest
an element of gain that is not yet, and may never be, income at the level of
the intermediary.

3.184 Some specific issues in relation to the operation of s. 26AAA(2A)
require examination. In attributing the proceeds of sale of the shares or
interest to the increase in value of the underlying property, the
Commissioner could not properly make an attribution in respect of
underlying property held by the primary intermediary, and at that same
time make an attribution in respect of an increase in value of underlying
property held by a sub-intermediary, where the latter increase in value will
have been reflected in the increase in value of the underlying property held
by the primary intermediary. A like point was made in [3.97] above in
regard to the operation of s. 25A(2).

3.185 There are difficulties in interpreting the condition imposed by s.
26AAA(2A)(d) that immediately before the sale of the shares or interest,
the value of underlying property whose increase in value gives rise to
assessable income found in the proceeds of the sale of the shares or
interest, must be not less than 75 per cent of the net worth of the company
partnership or trust in which the shares or interest are held. On one view
the condition must be satisfied in relation to each individual item of
underlying property. Such an interpretation would raise problems as to
what is an individual item of property. Another interpretation would
aggregate all items of property purchased by the primary or a sub-
intermediary within 12 months before the sale of the shares or interest.
That interpretation would be unacceptable in the respect that it involves
what might be called double counting of the kind identified in [3.97]
above. An acceptable interpretation would require an aggregation of all
underlying property that may properly give rise to assessable income found
in the proceeds of sale of the shares or interest.

3.186 The value of the underlying property that enters the calculation
required by s. 26AAA(2A)(c) must be not less than 75 per cent of the net
worth of the primary intermediary. Net worth is defined in s. 26AAA(1)(h)
as the total assets of the primary intermediary reduced by its total liabilities. Section 26AAA(10) is directed against action that might be taken to increase that net worth by discharging liabilities, or by the acquisition of assets, for the purpose of ensuring that the value of the underlying property that enters the calculation will be less than 75 per cent of net worth. If the Commissioner is satisfied that the purposes of discharge or acquisition included such a purpose, he may disregard the discharge or acquisition. An increase in the assets of the primary intermediary will not achieve the purpose if the assets are purchased at their market value within 12 months of the sale by the taxpayer of his shares or interest in the primary intermediary. Indeed it will defeat that purpose. The cost of purchase will leave the net worth of the intermediary unaffected. But a raising of capital by the primary intermediary would achieve the purpose of diminishing the fraction that the underlying property that enters the calculation represents of the net worth of the primary intermediary. It may be noted that conversely a primary intermediary that relies heavily on loan capital, and has little share capital or reserves, will very easily cause the taxpayer to be caught by the condition that underlying property that enters the calculation is not less than 75 per cent of net worth.

3.187 Action might be taken to diminish the value of an item of underlying property, for example by the issue of options or rights in respect of shares that are underlying property. The options or rights would not themselves be items of underlying property that are relevant to the operation of s. 26AAA(2A). They have not been purchased within the meaning of the word in s. 26AAA. Action of that kind might be within the general anti-avoidance provisions of Pt IVA, considered in Chapter 15 below.

3.188 The field of operation of s. 26AAA(2A) is not affected by 26AAA(5). That subsection applies only to s. 26AAA(2). Moreover the concept of excepted property, relevant in regard to the holding of property by an intermediary, is not relevant to the taxpayer's holding of shares or an interest in the intermediary. It follows that s. 26AAA(2A) is applicable where the taxpayer held shares or an interest acquired more than 12 months before their sale, even though he held the shares or interest as trading stock or as an asset acquired for the purpose of profit-making by sale, or in carrying out a profit-making undertaking or scheme, within the field of s. 25A(1). The Commissioner will no doubt ignore the possible operation of s. 26AAA(2A) in such circumstances if the operation of the law in regard to trading stock or s. 25A is likely to yield the higher amount of income. An examination of every sale of trading stock of a share trader in terms of the possible application of s. 26AAA(2A) would not be administratively...
feasible. There is no provision in s. 26AAA allowing the Commissioner to lift the operation of s. 26AAA(2A), in a way that might correspond with the provision in s. 25A(3).

3.189 Reference was made, in [3.174] above, to another set of provisions added to s. 26AAA in 1982 to close another avenue of escape from the intended operation of s. 26AAA. The way of escape involved a distribution in specie by a company or trust estate of property purchased within 12 months of the distribution, and a sale of the property by the person who took the property in the distribution. The distribution in specie, it would be argued, is not a sale within the use of that word in s. 26AAA, and it would be argued that the receipt of the distribution is not a purchase within the meaning of that word in s. 26AAA. Section 26AAA(1)(f) would presumably not operate to treat the distribution as a sale and purchase. The transfer is not in exchange for other property. It is a transfer in satisfaction of rights of the transferee, not in exchange for those rights. It is not a transfer without consideration any more than a payment by a debtor to his creditor is a transfer without consideration. The consideration is an extinguishment of the transferor's liability to pay. There is not in any case a receipt of proceeds of the sale from which the profit that is income may be determined, though that argument may be overcome by the operation of s. 26AAA(4) which, if there is a sale, will deem there to be a consideration of an amount that in the Commissioner's opinion is the value of the property. Section 26AAA(4) is confined to a sale that the Commissioner is satisfied was made between persons not dealing with one another at arm's length.

3.190 Section 26AAA(8) applies to a distribution of property of a private company or a private trust estate that has been made to a taxpayer in his capacity as a shareholder in the company, or as a beneficiary of the trust estate. It applies whether the distribution was in the course of winding up of the company or trust estate or otherwise. The distribution must be a distribution of the whole or part of underlying property. Underlying property in this context is property purchased by the company or trust within 12 months immediately preceding the date of distribution, excluding property that is excepted property of the company or trust estate of the kind referred to in subparas (i) or (ii) of s. 26AAA(1)(m). Items within subparas (i) and (ii) of s. 26AAA(1)(m) are trading stock and property being plant or articles within the meaning of s. 54 purchased for use by the company or trust for the purpose of producing assessable income. Underlying property distributed to the taxpayer is referred to as prescribed property. There is a condition that the prescribed property immediately before the distribution of the whole or part of it was made, must have had a value not less than 75 per cent of the net worth of the company or trust estate. And there is a
condition that the taxpayer would not, apart from s. 26AAA(8), be taken to have purchased the prescribed property.

3.191 The last condition contemplates the possibility that the distribution could, in particular circumstances, amount to a purchase by the taxpayer. A company or trust may effect a distribution by selling property to a shareholder or beneficiary for less than its value. In which event, there would be successive operations of s. 26AAA(2) on the sale to the taxpayer and on his further sale of the property if it was made within 12 months following his taking of the distribution.

3.192 If all these conditions are satisfied the taxpayer is deemed to have purchased the prescribed property, on the dates on which the prescribed property was purchased by the company or trustee of the trust estate, for an amount of consideration that the Commissioner considers appropriate having regard to two matters. The first matter is the amount of consideration given or agreed to be given by the company or the trustee in respect of the purchase of the prescribed property. The second matter is the nature and extent of the taxpayer's shareholding in the company or his interest in the trust estate. The first matter contemplates that the profit that will be taxed to the taxpayer should include the increase in value between purchase by the company or trust and sale by the taxpayer. A rational explanation of the relevance of the second matter is not evident.

3.193 Where the company or trustee of the trust estate incurred expenditure in relation to the prescribed property in addition to the consideration given or agreed to be given on or in respect of the purchase, the taxpayer is deemed to have incurred such amount of that expenditure as the Commissioner considers reasonable, having regard to the nature and extent of the taxpayer's shareholding or the taxpayer's interest in the trust estate. Again the relevance of the matter is not evident.

3.194 The operation of s. 26AAA(8) is to deem a purchase by the taxpayer at the time of purchase by the company or trust estate, and to provide for the fixing of the cost on the deemed purchase. Whether any derivation of income results will depend on the fact of sale of the property by the taxpayer, and the time of that sale. The derivation of income will arise from the operation of s. 26AAA(2).

3.195 Section 26AAA(9) seeks to cover a distribution that is made by the company or trust estate to the taxpayer through another trust estate in which the taxpayer is a beneficiary. It may be wide enough to cover a distribution through a number of trusts. There is no provision however that would cover a distribution to the taxpayer through another company or a series of companies.

3.196 The distribution of property by the company or trust estate may give
rise to assessable income derived by the taxpayer. The distribution though made in specie may yet be a dividend out of profits that is assessable income under s. 44. The distribution of property by the trust estate may be made in the exercise of a discretion, such that s. 101 will deem the beneficiary to be presently entitled to the amount of the distribution so that he is subject to tax under s. 97, or so that the distribution is subject to tax, immediately in the hands of the trustee, and ultimately in the hands of the beneficiary under s. 98 and s. 100, or s. 98 and s. 98A. In these circumstances the amount of assessable income arising under s. 26AAA is reduced by the amount of assessable income thus arising to the beneficiary by reason of the distribution. This is the effect of s. 26AAA(11). Where the distribution is made through an interposed trust there is a prospect of a levy of tax on the distribution as it moves through the interposed trust. The tax may have resulted from the operation of s. 97, s. 98, s. 99 or s. 99A. If in the opinion of the Commissioner the prescribed property or part of the prescribed property represents an amount included in assessable income of the taxpayer under s. 97, or represents an amount in respect of which the trustee of the interposed trust has been assessed and liable to pay tax in pursuance of ss 98, 99 or 99A, the amount of assessable income arising under s. 26AAA is reduced by that amount. The intention of s. 26AAA(11) is to prevent what would otherwise be thought to be double taxation—tax on the amount of the distribution that is the prescribed property and tax on the profit that is income on the sale of the prescribed property.
Chapter 4: Income by other Specific Statutory Provisions

4.1 In dealing with the contribution to the meaning of income for purposes of the Assessment Act that is made by the ordinary usage meaning of income, attention was at all times drawn to the possibility that the contribution that might otherwise have been made by the ordinary usage meaning has been denied, or been limited or modified, by some specific provision of the Act. A possible operation of a specific provision in this way is an aspect of the analysis, referred to in [1.30]ff. as the central provision analysis, which asserts that any item which enters “assessable income”, in the sense of an amount from which allowable deductions are subtracted to bring out an amount of income on which tax is levied, must have entered through the word “income” in the phrase “gross income” in s. 25(1). And it is an aspect of the analysis, referred to as the single meaning analysis, which asserts that the word “income” as used in the Assessment Act has only one meaning, a meaning to be drawn from all the provisions of the Act.

4.2 It was noted that the analyses, referred to as the parallel provisions and two meanings analyses, which are given some recognition in judicial decisions, must reject the possibility that the contribution of the ordinary usage meaning can be denied, limited or modified by some specific provision of the Act which purports to give meaning to the word income. Dixon C.J. in W. E. Fuller Pty Ltd (1959) 101 C.L.R. 403, Windeyer J. in Gibb (1966) 118 C.L.R. 628, and Stephen J. in Reesec (1975) 133 C.L.R. 45 would insist that the ordinary usage meaning of income is adopted by s. 25(1) in the phrase “gross income”. Any item that is income by ordinary usage, which is not expressly excepted from the operation of s. 25(1), is thus necessarily income for purposes of the Assessment Act and, subject to the tests of jurisdiction and exemption embodied in s. 25, is carried to assessable income. None of the judges referred to directs attention to the possibility that the Act might, in some specific provision, have qualified the operation of s. 25(1) by expressly providing that some item is not income. A provision which may qualify the operation of s. 25(1) in this way is s. 23E, relating to Special Bonds defined in s. 23E(3). It reads, in subs. (1): “Subject to sub-section (2), no part of the amount received by a person upon the redemption of a Special Bond, other than a part of that amount paid as accrued interest, shall, for any purpose of this Act, be taken to be income derived by that person.” Nor does any of those judges direct attention to the possibility that the Act might, in some particular respect,
have expanded the operation of s. 25(1) by deeming an item to be income by ordinary usage. *Harrowell* (1967) 116 C.L.R. 607 may be explained on the basis that the item in question was deemed by s. 47 to be income by ordinary usage. In *Rutherford* (1976) 76 A.T.C. 4304 the Commissioner argued, though un成功fully, that s. 108 which deems certain receipts to be dividends, had the effect of making those receipts income by ordinary usage and thus income by force of s. 25(1).

**4.3** These possibilities could be accommodated within the parallel provisions and two meanings analyses. But the possibility that a specific provision, by saying that an item is not assessable income or by omitting an item in saying that a class of items is assessable income, has qualified the operation of s. 25(1), cannot be accommodated. This is evident in the judgment of Stephen J. in *Reseck*. The fact that s. 26(d) dealt only with 5 per cent of the amount of a retiring allowance which is income by ordinary usage, did not qualify the meaning of income in s. 25(1). If it was to be taken to express an intention that the other 95 per cent was not assessable income—which Stephen J. thought was not the case—the most that it could have done was to make that 95 per cent exempt income. It would have been exempt income, presumably because of the definition of exempt income in s. 6, which refers to “income which is not assessable income”.

**4.4** It is true that Gibbs J. in *Reseck* held that a “contrariety” between s. 25 (1) and s. 26(d) required a conclusion that s. 25(1) did not make the 95 per cent income. And Jacobs J. reached the same conclusion by reasoning that the “special provision in s. 26(d) must be given its effect in preference to the general provision in s. 25(1)” (at 57). It is true also that they reached the conclusion after verbal reference to the parallel provisions and two meanings analyses. The conclusion is, none the less, a rejection of those analyses. The analyses would assert that the operation of s. 25(1), in carrying items to assessable income, is quite independent of the operation of any specific provision, so that “contrariety” or a relationship of general and special cannot arise. The conclusions reached by Gibbs and Jacobs JJ. can only be explained on the basis that the Act has only one meaning for the word income.

**4.5** Reference has already been made in [1.39], [2.223] and [2.369] above to the apparent endorsement of the parallel provisions and two meanings analyses of the structure of the Assessment Act, reflected in the words added to s. 25(1) in 1984. The words are: “[which is not] . . . an amount to which s. 26AC or s. 26AD applies or an eligible termination payment within the meaning of Subdivision AA [of Division 2 of Part III].” The words let in all the unacceptable consequences of the parallel provisions and two meanings analyses, both those that flow from the dissenting
judgment of Stephen J. in Reseck (1975) 133 C.L.R. 45 and those that will leave the Assessment Act without coherent bases of jurisdiction. And the words added to s. 25(1) do more than this. At least the view adopted by Stephen J. could resolve a conflict between s. 25(1) and a specific provision where the ordinary usage notion of income had a wider operation than a specific provision that shows a clear intention to exclude from assessable income some item of what is income by ordinary usage. The Stephen J. resolution—that the item of ordinary usage is made exempt income—may draw no support from the policy of the Assessment Act, but it is at least a resolution. That resolution is no longer possible. The words added carry an inescapable implication that the only manner in which an item of ordinary usage income can be denied entry to assessable income is by an express provision in s. 25(1), the section that otherwise carries all items of ordinary usage income to assessable income. Thus, despite the clear intention of s. 27H that an annuity receipt should not be assessable income to the extent of the amount excluded by that section, the whole amount of the annuity will be carried to assessable income by s. 25(1). Avoiding consequences of this kind is probably beyond judicial interpretation of the Assessment Act, though Cooper Brookes (Wollongong) Pty Ltd (1981) 147 C.L.R. 297 and the provisions of ss 15AA and 15AB of the Acts Interpretation Act might encourage a court to try. More appropriately, the Assessment Act should be amended to remove the words added in 1984 to s. 25(1) and to add words to ss 26AC, 26AD, 27B and 27C so that, within their fields of operation, they exclusively determine what is assessable income for purposes of the Assessment Act. The opportunity might be taken to ensure, where this is the intention of the Act, that other specific provisions operate as codes, though it might be preferable to leave the question whether other specific provisions are codes to judicial determination. The way will be left for judicial determination if the words by which ss 26AC, 26AD, 27B and 27C are made codes are expressed to be without prejudice to the possible exclusive operation of other specific provisions.

4.6 In what follows in this chapter the central provision and single meaning analyses are maintained. The word “income” in s. 25(1), and anywhere else in the Act, has a meaning which is drawn from all the provisions of the Act. It is the meaning of ordinary usage, confirmed, extended, limited or modified by specific provisions. The parallel provisions and two meanings analyses, taken with the words added to s. 25(1), produce chaos that awaits legislative action.

4.7 Some income is exempt, and does not enter assessable income because its entry is denied by s. 25(1). Income will be exempt where the Act
expressly says that it is exempt. And the Act may impliedly make it exempt by saying that it is “not assessable”: at least this appears to be the assumption of the definition of exempt income in s. 6. The reference to income that is not assessable income in the definition could be explained as a reference to items of income which fail to enter assessable income because they are outside the jurisdiction asserted by s. 25(1), being foreign source income of a non-resident. It is so explained by Barwick C.J., McTiernan and Taylor JJ. in Gibb (1966) 118 C.L.R. 628 at 633–634:

“Nor do we think that on the taxpayer's reading of the definition of exempt income ‘the second part of it would add nothing and would be altogether otiose’. It is sufficient to point out that the assessable income of a non-resident taxpayer is limited to his ‘gross income derived directly or indirectly from all sources in Australia’. His ex-Australian income is not assessable income for the purposes of the Act though s. 23(r) goes on to exempt from income tax income derived by such a taxpayer from sources wholly out of Australia. However, the dividend income of a non-resident taxpayer paid out of profits derived partly in Australia and partly outside Australia is not the subject of an express exemption, but it is clear that his assessable income for purposes of the Act includes only those dividends to the extent to which they are paid out of profits derived by the company from sources in Australia (s. 44(1)(b)). The remainder of his dividend income is, therefore, income which is not ‘assessable income’ but it is ‘exempt income’ pursuant to the second part of the definition of that term for the purposes of the Act including s. 80.”

However, the reference to income that is not assessable income in the definition of exempt income in s. 6 does, it seems, extend to income expressly made not assessable by s. 128D (income subject to withholding tax). There is an assumption that it does, in s. 80(3)(b) in defining “net exempt income” in relation to loss carry forward. It might be thought that the definition should also extend to income in the form of film and video tape royalties derived by a non-resident, to which Div. 13A of Pt III applies. It is expressly provided in s. 136A(4) that such income “shall not be included in the assessable income of a person”. One would have expected s. 80(3)(b) to contain a reference to s. 136A(4), as well as to s. 128D.

4.8 The central provision and single meaning analyses do not exclude the possibility that a specific provision such as s. 44(2), with which W. E. Fuller Pty Ltd (1959) 101 C.L.R. 403 and Gibb (1966) 118 C.L.R. 628 were concerned, may, in the use of a phrase such as “not assessable income”, make some item of income exempt. The specific provision can of course have this effect only where the item is one that is within the Assessment Act's concept of income. The question of construction in Fuller and Gibb was whether the words “the assessable income shall not include” in s. 44(2) had the effect of making the item—bonus shares—in any respect exempt income. There were in effect two questions: whether the item was in any respect income, either by virtue of the ordinary usage meaning of income or by the specific provisions of s. 44, and whether the
words operated to exempt that income. Dixon C.J. concluded that the item was not income. The majority in Fuller (Fullagar and Menzies JJ.) concluded that it was, and that the words used made this income exempt. Gibb by majority, overruled Fuller on the question whether the item was income. The possible operation of the words of s. 44(2) to bring about an exemption did not arise.

4.9 While it is thus a possible operation of words which refer to an item as “not assessable income”, in the course of some specific provision giving meaning to the Assessment Act's concept of income, that they make income exempt, it is not an operation that ought readily to be given to the words. An operation of the words “not assessable income” in this way assumes that the specific provision has confirmed some aspect of the ordinary usage meaning, or has extended the ordinary usage meaning, and has then by a choice of the words used in the s. 6 definition attributed exemption to it. The more likely construction is that the words used simply limit the confirmation or extension of the ordinary usage meaning. A failure to confirm on the central provision and single meaning analyses may, in this context, simply carry the implication that the item not confirmed is not income for the purposes of the Assessment Act. It is an implication which is directed by the use of the words “not assessable income”. Indeed any other implication would seem to be perverse. It is a most unlikely legislative intention that the specific provision confirms the ordinary usage meaning in respect of some item, or extends it in respect of some item, and then by the use of the words “not assessable income” makes that item exempt income.

4.10 Where a specific provision in confirming an aspect of the ordinary usage meaning does so in a way that requires an inference that it is intended to be a code dealing with this and related aspects, it will have excluded those related aspects of ordinary usage from the Act's concept of income. This was the construction given to s. 26(d) by the majority in Reseck (1975) 133 C.L.R. 45. In this case, items within those related aspects are not income within the Assessment Act's meaning. There is no basis for saying that the items are within the Assessment Act's meaning, but have been made impliedly “not assessable income” so as to be exempt by virtue of the definition in s. 6. On the central provision and single meaning analyses, the conclusion contemplated though not in fact drawn by Stephen J. in Reseck, could not be drawn. If he had thought that s. 26(d) was intended as a code dealing with lump sum allowances paid in consequence of retirement from, or termination of office or employment, he would have held that the 95 per cent of the allowance received in Reseck that was not made income by the code, was exempt income. The prospect
of such a conclusion must condemn the analyses that make it possible.

4.11 Chapter 3 above has been devoted to a survey of two specific statutory provisions, s. 25A and s. 26AAA, which bear on the meaning of income for purposes of the Assessment Act. The survey that follows of other specific statutory provisions which bear on the meaning of income in the Assessment Act, is arranged by reference to the propositions as to the ordinary usage meaning of income in Chapter 2 above. In some instances a provision will need to be considered more than once. Where the provision has already been considered in Chapter 2 or 3 above, the present treatment is very little more than a cross-reference. Where the provision is the subject of extended treatment in later chapters, only an outline is given in the present treatment, and a cross-reference is given to the later chapter. Under each heading specific provisions are dealt with in the order of their appearance in the Assessment Act.

Derivation: Proposition 1

4.12 The view taken in this Volume is that derivation is an aspect of income. The income quality of an item must be assessed in the hands of the person who has derived it. It follows that a delay in derivation may have the consequence that an item never comes to be the income of any person, because at the time of derivation the circumstances do not give the item an income character, though circumstances of an earlier time might have given that character had derivation been at the earlier time. Constable (1952) 86 C.L.R. 402 referred to in [2.17]–[2.19] and [2.22] illustrates this consequence. And it follows, at least in theory, that derivation may come too soon. The derivation may be at a time when the circumstances which would give the item an income character do not yet obtain. Problems of derivation are problems of tax accounting, and are dealt with in Chapters 11–14 below. For the present it is sufficient to observe only briefly on specific provisions more closely considered in those chapters.

Section 6C(1): The derivation of royalties

4.13 Section 6C(1) does not directly bear on the issue of derivation. The history of the section does, however, show how the separation of the moment of derivation from another moment when an item comes to have a quality necessary for its inclusion in assessable income, will preclude any inclusion. At the time of the facts of the Aktiebolaget Volvo (1978) 78 A.T.C. 4316, s. 6C of the Act gave a source in Australia to royalties “paid” by an Australian resident to a non-resident. The definition of royalty
extended to certain amounts “paid”. Jenkinson J. in Volvo observed that if an amount became payable to a taxpayer in one year so as to be derived by him in that year, an accruals basis of accounting being applicable, but the amount was not paid to him in that year, the amount would not be given an Australian source. Indeed it would be more correct to say that if there was a moment of derivation in advance of the moment of payment, even though both moments occur in the same year of income, the amount derived would not be given an Australian source by s. 6C.

4.14 Following the Volvo decision, the definition in s. 6 was amended by Act No. 24 of 1980 so that it now covers amounts “paid or credited”. Some weeks after this amendment, it being considered that the amendment to s. 6 was insufficient to cover the weakness exposed in the Volvo judgment, s. 6C was also amended so that it now covers amounts “paid or credited”. The assumption of both amendments seems to have been that “crediting” by a debtor involves a derivation by an accruals basis taxpayer in whose favour the item is credited. There is no basis for such an assumption. The accrual is complete when a non contingent right of the taxpayer to receive an ascertained amount arises—crediting merely records that right of the taxpayer in the books of the debtor. The weakness exposed by the Volvo decision still remains. If it is correct that royalties in the circumstances of Volvo are to be accounted for on an accruals basis, an amount will not have an Australian source, so that it might enter assessable income under s. 25, if a right to receive arises and its source in Australia depends on s. 6C. It may come to have an Australian source when an entry is made in the debtor's books or it is paid to the creditor, but this does not assist the entry into assessable income. The item must have an Australian source at the time of derivation. Both in the s. 6 definition and in s. 6C the word “derived” should replace “paid or credited”.

Section 19: constructive receipt

4.15 Section 19 may do no more than confirm a principle of constructive receipt as an aspect of the notion of derivation by a taxpayer who is on a cash basis of accounting. The section has been the subject of interpretation in a number of cases including Permanent Trustee Co. of N.S.W. (1940) 6 A.T.D. 5, Gair (1944) 71 C.L.R. 388, Brent (1971) 125 C.L.R. 418 and Poole & Dight (1970) 122 C.L.R. 427. This interpretation is considered in Chapter 11 below. The importance of s. 19, and the principle of constructive receipt, for the rational operation of the Assessment Act, cannot be overemphasised. The function of the section, and of the principle, is to bring about a derivation at a time when the circumstances of
the derivation may still give an income character to the item. If a cash basis taxpayer assigns a debt due to him, for example, a debt for professional services rendered, s. 19 or the principle may treat the assignment as a derivation. If it does not, the item may never be income derived by anyone. It will not be income of the assignor because he has not derived it. It will not be income of the assignee because the circumstances of any derivation by him—the receipt of payment—will not give the item an income character: *Federal Coke Co. Pty Ltd* (1977) 77 A.T.C. 4255. If a cash basis taxpayer, being entitled to an amount for professional services, agrees that the amount to which he is entitled should be lent to the debtor, s. 19 or the principle may treat his agreement as a derivation. If it does not, the item may escape ever being treated as income derived. When the taxpayer receives payment he receives repayment of a loan, and this circumstance will not give the item an income character.

**Sections 25A, 26, 26AAA: profit arising, benefit given, item received**

4.16 The present concern is whether the ordinary usage notion of derivation, otherwise adopted by s. 25, is displaced by any of these provisions.

4.17 Clearly there is no displacing when the relevant provision itself uses the word “derive”. Thus, s. 26(b) refers to “beneficial interests in income derived”. Sections 25A and 26AAA, in their reference to “profit arising”, should not be held to have displaced the ordinary usage notion of derivation in relation to a profit. Where the word used is “received”—it is used in paras (f), (g), (h), (i), (j), (ja) and (l)—it is arguable that the effect is to put all taxpayers on a cash basis of accounting in relation to the relevant item, though it is more likely that the word received will be read as equivalent to “derived” and the general principles of tax accounting remain unaffected.

4.18 Paragraphs (e) and (ea) of s. 26 give rise to more difficulty. The words “allowed given or granted” are explained in *Constable* (1952) 86 C.L.R. 402 and *Dixon* (1952) 86 C.L.R. 540 in ways which suggest that they have a meaning which displaces the general principles of tax accounting. The benefit must have been allowed given or granted “to the taxpayer”. If s. 26 (e) is a code, a possibility canvassed in [2.367]–[2.373] above and [4.42] below, those words may exclude the operation of the constructive receipt principles of ordinary usage derivation.

4.19 Paragraph (eb) of s. 26 refers to any amount “paid to the taxpayer”. Paragraph (jb) refers to an amount “paid to the taxpayer or applied by the Commissioner in discharge or partial discharge of a liability of the
taxpayer to the Commonwealth”. The significance of the use of the words “paid to the taxpayer” is examined in Chapter 11 below. The express provision in para. (jb) referring to an amount “applied by the Commissioner” may have a bearing on the construction of s. 19, and on the scope of the ordinary usage principle of constructive receipt. It strengthens an argument that moneys “are not dealt with on [the taxpayer's] behalf or as he directs”, nor are they constructively received, when the creditor applies an amount owed to him by the taxpayer in satisfaction of an amount owed by the taxpayer to the creditor. Issues of this kind are considered in Chapter 11 below.

Section 26AAC: derivation of shares and rights to shares

4.20 Reference was made above in [2.25]–[2.26] and [2.35] to the specific provisions of s. 26AAC which provide tests of derivation where the item is a right to a share, or a share in a company, made available to an employee. There is a derivation when a share is acquired, and that acquisition is deemed to occur when the right of the taxpayer to dispose of the share ceases to be restricted in the ways referred to in the section, or when he ceases to be liable to be divested of his ownership of the share, or the time “immediately before the taxpayer disposes of the share”, whichever first happens (subss (5) and (15) of s. 26AAC). There is a derivation when a right to a share is acquired and the taxpayer disposes of the right to a person who is not an associate of the taxpayer (s. 26AAC(8)). Problems of double taxation that may result from the derivations thus arising under s. 26AAC, and the derivations that may arise under other provisions, are dealt with in subss (11) and (12) of s. 26AAC, and are considered in [2.25]–[2.26] above, and in [12.165]–[12.180] below.

4.21 An attempt is made in s. 26AAC to displace ordinary usage derivation within principles determined by Abbott v. Philbin [1961] A.C. 352 and Donaldson (1974) 74 A.T.C. 4192, and thus avoid yet another prospect of two derivations and the double inclusion of an item in assessable income. Section 26AAC(10) displaces the operation of s. 26(e). But it does not expressly displace derivation of ordinary usage income. The inference may be that s. 26(e) is a code which has, in its turn, displaced ordinary usage derivation, though that inference seems hardly consistent with judicial observations in Dixon (1952) 86 C.L.R. 540, Hayes (1956) 96 C.L.R. 47 and Scott (1966) 117 C.L.R. 514. And the point has already been made in [4.5] above that so long as the words added in 1984 to s. 25(1) remain, it is impossible to treat any specific provision as a code save those mentioned in those added words.
Section 26BA: a deferral of derivation

4.22 Section 26BA displaces the ordinary usage principles of derivation, by deeming income derived by ordinary usage in one year, to be derived in a later year. The purpose of the section is to overcome the bunching of income in one year. A number of other sections, including s. 26B, which also operate to bring about deemed derivations, have the same purpose.

Subdivision AA of Division 2 of Part III: an extended notion of constructive receipt

4.23 Sections 27B and 27C of Subdiv. AA of Div. 2 of Pt III will include, in whole or in part, an eligible termination payment “made in relation to a taxpayer”, in the assessable income of the taxpayer. “Eligible termination payment” is defined so that it means a payment of specified kinds “made in respect of the taxpayer”, and s. 27A(3) defines the latter words so that they are a reference to a payment made:

“(a) during the life of the taxpayer—

(i) to or for the benefit of the taxpayer;
(ii) to or for the benefit of a dependant of the taxpayer; or
(iii) to another person at the direction or request of the taxpayer; or

(b) after the death of the taxpayer—to the trustee of the estate of the taxpayer.”

The “taxpayer” for purposes of an “eligible termination payment” within para. (a) of the definition of eligible termination payment in s. 27A(1), is the person whose employment is terminated. The consequence of this drafting is to include in the assessable income of the taxpayer an amount that might not have been regarded as derived by him if only ordinary usage principles of derivation were applicable. The possibility that the amount might, in the particular circumstances, be income of the dependant or other person or trustee of the taxpayer's estate, and the prospect of double taxation, are handled by an involved drafting device in s. 27A(5). If the amount is income of the dependant, other person or trustee, it will be taken out of the definition of eligible termination payment and thus out of the operation of s. 27B or s. 27C in relation to the taxpayer. The prospect remains that the taxpayer might derive income other than by virtue of s. 27B or 27C. He might be held to have constructively received what has been paid to the dependant, other person or trustee, and the amount is in other respects his income as a reward for services. Double taxation in that event could only be avoided if the ordinary usage principles of constructive
Section 44(1): the derivation of dividends

4.24 Section 44(1) provides that the assessable income of a shareholder includes dividends paid to him by the company. In this and other contexts discussed in [11.163]ff. below the Assessment Act appears to make derivation by a taxpayer depend exclusively on action taken by another.

Division 5 of Part III: the derivation of partnership income

4.25 The operation of ordinary usage principles of derivation in relation to income moving to partners through a partnership, would pose awkward problems, more especially where the entitlements of partners to share in profits are complex. And there would be problems in regard to the availability of deductions. These problems are avoided by Div. 5 which makes the partnership a tax accounting entity, in a manner which has its parallel in the provisions of Div. 6 in relation to trusts considered below. Section 90 provides for a calculation of a notional income for a year of income, of a hypothetical entity—the partnership as a taxpayer. Section 92 imputes a derivation of income by each partner, being a share of that notional income. The imputation depends on a specific provision in s. 92, which applies to the notional income the individual interest of each partner in the income of the partnership according to partnership law. The imputation cannot occur until the notional income of the hypothetical entity for the year of income becomes calculable, which will be at the last moment of the year of income. It follows that derivation by a partner of income moving to him through the partnership cannot occur until the last moment of the year of income. It is this that makes possible the transfer of income by the assignment of a share in a partnership, recognised in Everett (1980) 143 C.L.R. 440 and Galland (1984) 84 A.T.C. 4053.

Division 6 of Part III: the derivation of trust income

4.26 Division 6 displaces the operation of the ordinary usage principle expressed in Proposition 4—to have the character of income an item must be a gain by the taxpayer who derived it. And it displaces the principle expressed in Proposition 3 that the character of an item as income must be judged in the circumstances of its derivation by the taxpayer: a beneficiary in whose favour the trustee of a discretionary trust exercises his discretion will derive income by force of ss 101 and 97, though the quality as income
will have been determined by reference to the circumstances of a derivation by the hypothetical taxpayer referred to in s. 95.

4.27 The present concern is to note the specific provisions which govern derivation by a beneficiary, and displace the ordinary usage principles of derivation. Sections 97 and 98 substitute “present entitlement” and “vested and indefeasible interest” as the tests of derivation. And s. 101 deems a present entitlement when a trustee exercises his discretion “to pay or apply income . . . for the benefit of” a beneficiary. These tests of derivation operate in a special fashion. They are strictly tests of derivation of trust law income by the beneficiary. From that derivation a derivation of income for purposes of the income tax is imputed. The derivation imputed is a derivation of a share of the income for purposes of the income tax, derived by the hypothetical taxpayer referred to in s. 95—the share being the same as the beneficiary's share of trust law income.

4.28 There are no specific provisions concerned specially with the derivation of notional income by the hypothetical taxpayer in s. 95. The ordinary usage principles will apply, affected by other specific provisions now considered. Thus, where a trustee is a partner, the provisions of Div. 5 will apply. And where the trustee is a beneficiary in another trust, Div. 6 will apply.

4.29 Sections 99 and 99A displace the ordinary usage principles of derivation: they impute a derivation by the trustee in relation to such of the income derived by the hypothetical taxpayer referred to in s. 95, as is not the subject of an imputed derivation by a beneficiary by force of ss 97, 98 and 101.

4.30 Section 99B displaces the ordinary usage principles of derivation where property of a trust estate is paid to or applied for the benefit of a beneficiary. The derivation in this instance operates directly. It completes the income quality in the hands of the beneficiary of the property paid to or applied for his benefit.

Division 6A of Part III: deemed derivation of assigned income

4.31 Division 6A is directed against income splitting by transfer of income for short periods. The intention of the Division, expressed in s. 102B(1) is to impute a derivation by the transferor of income which, if it is in fact derived as income, will be derived by the transferee. The expression of that intention raises awkward problems of interpretation. Section 102B(1) provides:

“any income derived from the property that is paid to, or applied or accumulated for the benefit of the [transferee] by reason of the transfer, being income that, but for
the transfer, would have been included in the assessable income of the transferor, shall be treated for purposes of this Act as if the transfer had not been made.”

**4.32** There may be some doubt about the sufficiency of the deeming. The income is to be treated “as if the transfer had not been made”. One would have expected the deeming clause to add “and the income had been derived by the transferor”.

**Section 128D of Division 11A of Part III: derivation of income subject to withholding tax**

**4.33** Section 128D provides, in general, that income upon which withholding tax is payable “shall not be included in the assessable income of a person”. Reference has been made in [4.7] above to the likely construction of this provision that it makes income exempt income by making it not assessable. There is another possible construction which would treat s. 128D as having simply denied the element of derivation which is a condition of income being subject to tax by assessment. Other provisions of Div. 11A—in particular s. 128B—provide a notion of derivation in terms of “paid to” a person, specifically for purposes of withholding tax. On this analysis items subject to withholding tax are not income for purposes of tax by assessment.

**Realisable Value: Proposition 2**

**Sections 20, 21: the statutory expression of the realisable value principle**

**4.34** Sections 20 and 21 express the general usage principle that an item of an income character that has been derived will be income in the amount of its realisable value. An item of foreign currency is income in the amount of its market equivalent in Australian currency. Where the item is not currency, the money value of the item will be the amount of income. Section 21 is expressed in a way that might be thought to confine its operation to the determination of the amount of an outgoing. It is, however, applicable to any movement of consideration, and by requiring that the money value be treated as “paid or given”, it prescribes an amount for purposes of tax accounting whether the accounting is for an outgoing or an item of income, or for the determination of a loss which is deductible or a profit which is income.

**4.35** There is a question of the precise effect of s. 21 on the matter of derivation of an item of profit which is income or of a loss which is deductible. The principle expressed in Proposition 4 that an item to be income must be a gain, refers to a realised gain. There is a realised gain
when an asset is disposed of for an amount of money greater than its money cost, and there is a realised loss when it is disposed of for an amount of money less than its money cost. Whatever be the consequences of the ordinary usage meaning of income, s. 21 ensures that an exchange of assets neither of which is currency will be treated as the realisation of an asset for an amount of money which may include a profit or demonstrate a loss. And the section ensures that the exchange will be treated as the acquisition of an asset for a money cost, so that a profit or loss may arise when the asset is disposed of.

4.36 The view is taken in this Volume that the outlay of currency for an asset is, generally, not an event which calls for recognition in a present tax account. There is no outgoing which is deductible unless there are express statutory provisions which require that the currency outlaid must be treated as an outgoing: there are such provisions in ss 28ff. and s. 51(2), concerned with trading stock as defined in s. 6. Section 21 does not challenge that view. Where, however, an asset which is not currency is exchanged for another asset which is not currency, the exchange may involve the realisation of a profit or loss in relation to the asset disposed of. And it will be the occasion of establishing a cost of the asset acquired, as much as would be the outlay of cash for the asset acquired. In these situations s. 21 has an operation: *Executor Trustee & Agency Company of S.A. Ltd (Bristowe's case) (1962) 36 A.L.J.R. 271*, *Varty v. British South Africa Co. [1966] A.C. 381*. These matters are considered in [5.23]–[5.26] and in Chapter 12 below.

4.37 Section 21 is expressed in very wide terms—it deems the money value to have been paid or given “for purposes of [the] Act”. It should have the effect of requiring that a disposition of an asset which is not currency be treated as a payment for purposes of a provision of the Act whose operation depends on an item having been “paid”, or a “payment” having been made. Thus s. 27A(8), deeming a transfer of property to be a payment of an amount equal to the value of the property before the transfer, is unnecessary. The deeming is for purposes of Subdiv. AA of Div. 2 of Pt III referred to in [2.386]–[2.387] above and again in [2.419] and [4.183]ff. below.

Sections 26(e); 26AAAA; 26AAAB: the taxation of fringe benefits

4.38 Section 26(e) displaces the ordinary usage principle that an item is income in the amount of its realisable value, in the context of items which are derived “in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by [the taxpayer]”. The section goes
some way to defeating tax planning which depends on the giving of benefits other than money as rewards for services. The operation of s. 26(e) in relation to such “fringe benefits” has been the subject of comment in [1.81]–[1.84] above and [4.38]–[4.83] below. Its effect is to substitute “value to the taxpayer” for realisable value as the measure of the amount in which an item is income.

4.39 The meaning given to the phrase “value to the taxpayer” by Bowen C.J. in Eq. in Donaldson (1974) 74 A.T.C. 4192 at 4207 is “what a prudent person in [the taxpayer's] position would be willing to give for [the item] rather than fail to obtain [it]”. The fact that a benefit is subject to a restriction affecting the power of the taxpayer to transfer it to another may have a significantly depressing effect on its realisable value, but not on the amount a person in the position of the taxpayer would pay for the item. A benefit in the form of use of a motor vehicle, the taxpayer being forbidden to allow any other person to use the vehicle, has no realisable value, but a person “in the [taxpayer's] position”—a person who would therefore be entitled to use the vehicle—may be prepared to pay a substantial amount for the benefit. Which is not to say that a person in the position of the taxpayer would not pay more for the benefit if it were a benefit he could transfer to another.

4.40 The meaning given by Bowen C.J. in Eq. to the phrase “value to [the taxpayer]” leaves open a question whether the hypothetical person in the position of the taxpayer must be taken to have the tastes and financial resources of the taxpayer. The question is starkly raised where the taxpayer asserts that he would never have chosen to acquire the item provided for him by the employer, had it been offered to him at the price others would have asked him to pay for it. If the tastes and financial resources of the taxpayer are to be imputed to the hypothetical buyer, the operation of s. 26 (e) must become utterly unpredictable. The point is made below in dealing with subsidised housing that to allow the financial circumstances of the taxpayer to affect the value to the taxpayer is to invite a conclusion that luxury has no value to a taxpayer who cannot afford it if he must buy it for himself.

4.41 There is a question whether the prudent person in the position of the taxpayer must be taken to have the special knowledge which the taxpayer has. It may be difficult to assert at once that the taxpayer's tastes and financial circumstances are irrelevant, and that his special knowledge is relevant. If his special knowledge is relevant it would follow, in an Abbott v. Philbin [1961] A.C. 352 or Donaldson (1974) 74 A.T.C. 4192 situation, that the value to the taxpayer may be higher or lower because of the special knowledge the taxpayer had, special knowledge indicating a prospect of an
increase or a decrease in the value of the company's shares.

4.42 If tastes, financial circumstances and inside knowledge of the taxpayer are relevant, they may cause the value to the taxpayer to be less than the realisable value. The question would then arise whether there is none the less a derivation of income in the amount of the realisable value. The answer would depend on whether s. 26(e) is a code covering the particular context. The question whether s. 26(e) is a code is now inextricably linked with the effect of the words added in 1984 to s. 25(1) in ways that have been explained in [4.5], [2.367]–[2.373] above. It might be thought a strange outcome of a conclusion that it is a code that a teetotal taxpayer who has accepted a gift of expensive liquor has derived a valueless item, and there is no amount of income, even though he can sell the item for a substantial sum.

4.43 The exclusion by s. 26(e) of the principle in Tennant v. Smith [1892] A.C. 150 gives rise to a question of characterisation which cannot arise when ordinary usage principles are alone applicable. Where the item allowed, given or granted is neither money nor capable of being turned into money there is room for argument, in some circumstances, that it is not a product of his employment, which would make it income, but rather a “condition” of his employment. Thus the flat which a caretaker occupies in his employer's building, the cabin occupied by a sailor on his ship and the room occupied by a doctor who is required to be on immediate call at a hospital, may not be “benefits” under s. 26(e).

4.44 In some situations accommodation provided for an employee may be in part a “condition” of employment and in part a “benefit” to the employee. Thus he may be called on to entertain in his employer's interests, and the house provided for him has space and facilities for this purpose. He may use a company car on the company's business and for private purposes. There is a question whether an apportionment is proper in such a case. Hayes (1956) 96 C.L.R. 47 may indicate that an apportionment is not proper and that the dominant purpose governs. The application of the phrase “benefits in kind” in United Kingdom legislation in the Court of Appeal decision in Westcott v. Bryan [1969] 2 Ch. 324 on the other hand would support the view than an apportionment is proper.

4.45 The value to the taxpayer of a benefit ought not to be less than the amount that he might obtain by surrendering the benefit. In Heaton v. Bell [1970] A.C. 728 the provision of a car by his employer involved a subtraction from his salary. A surrender of the car would have restored his salary to its previous amount. In this instance the amount of income will not differ whether s. 26(e) or ordinary usage principles are applicable, save where the amount obtainable by surrendering has been set at a low figure,
in order to limit its realisable value.

4.46 The operation of s. 26(e) in circumstances where the immediate recipient of a benefit provided by the employer is not the taxpayer but a third person, who may be a relative of the taxpayer, is less than clear. The phrase “value to [the taxpayer]” might appear to deny that the taxpayer has derived any amount of income beyond the value to him of any benefit that he may derive indirectly, for example by relief from some legal or moral obligation binding him to provide for the relative the direct benefit provided by the employer. The employer might have paid the school fees of the taxpayer's child. Ordinary usage derivation might be even more limiting on the amount that could be regarded as income. There will be circumstances in which the taxpayer might be taken to have received constructively the amount expended by the employer in providing the benefit to the relative. Constructive receipt principles are examined in [11.122]ff. and [13.66]ff. below where the view is expressed that a stipulation in a contract of service that a payment be made to another will not at any time give rise to a constructive receipt by the person who makes the stipulation. The circumstances do not involve an assignment of income which could give rise to a derivation by the person who makes the stipulation.

4.47 Where there is no stipulation express or implied in the service agreement, the possibility of ordinary usage derivation is even more remote. The provision of a benefit to the relative may take the form of funding a scholarship scheme for children of employees. The taxpayer employee was held to have derived income in these circumstances in *Wicks v. Firth* [1983] 1 All E.R. 151, but the decision involved the application of special provisions of the United Kingdom law. In Australia, ordinary usage derivation would be confined to the realisable value of the indirect benefit to the taxpayer employee, and there would appear to be no realisable value. In any event *Constable* (1952) 86 C.L.R. 402, discussed in [2.17] and [2.22] above, may stand in the way of a conclusion that the benefit to the taxpayer is a reward for services.

**Use of a motor vehicle**

4.48 Section 26(e) uses a number of words to identify the item that is income—allowances, gratuities, compensations, benefits, bonuses and premiums. Where the item is not money, there are problems in isolating the item that is income where the taxpayer has obligations to the person providing the item in regard to its use, and where the taxpayer's use of that item is in some degree inherent in performing the services for which it is a
reward. An obligation to maintain a motor vehicle, and to keep it in a parking space, will limit the benefit provided in the form of use of the vehicle. Where the motor vehicle is used by the taxpayer in performing services for his employer, the use of the vehicle is not in this respect an income item. The use is not a benefit from the employment: it is a condition of employment, no different from the office space, light and heating provided for an employee engaged in office work.

4.49 Isolating the income item that may be involved in the use of a motor vehicle becomes a subtle, and in terms of demands on the administration of the income tax, a costly exercise. A principle, discussed in [8.57]–[8.82] below, that the costs of travel to and from work are not a deductible outgoing, suggests that the use of a car provided by an employer to travel to and from work should be regarded as an income item. But the employee may argue that the use of the car in this way is simply inherent in performing his services: it is inherent in carrying out his obligation to maintain and keep the car safe, and to have it available at all times to travel on some duty away from his normal place of work.

4.50 In 1974 provisions were inserted in the Assessment Act—a former s. 26AAB—which sought to avoid these subtleties, by providing that a “standby value” of a vehicle provided by an employer would be an income item of an employee, wherever there was any private use of the vehicle by the employee. The provisions deemed use for travel to and from work to be private use. The provisions were repealed, with retrospective effect, in 1975. The reason given for the repeal was the serious effect on the motor vehicle manufacturing industry, and employment in that industry, that would result from what was seen as a tax disincentive to employees using vehicles provided by their employers. An inequity in the income tax which is sufficiently entrenched, may be beyond any action to redress it.

Free or subsidised housing

4.51 Isolating the item that is income when free or subsidised housing is provided by an employer is also a subtle exercise. An obligation on the employee to use the house to entertain clients of the employer must limit the benefit provided, and where the employee has some caretaking function to perform—the housing may be in a building where the employer's business is conducted—there is room for an argument that, at least in part, the taxpayer's use of the housing is inherent in performing the services. It is a condition of service, and is not a reward for service.

4.52 The fact that there is an obligation on the employee to use the house to entertain clients may not only limit the benefit, but also require that
some of the apparent benefit that remains should be treated as inherent in performing the services. It may be argued that the enjoyment of “prestige” housing provided by the employer is a condition of employment. The employer's “image” is furthered by the quality of the housing provided for the employee, in the same way as that image is furthered by the luxury of the motor vehicle provided for the employee.

4.53 The method of valuation contemplated by s. 26(e) is qualified by ss 26AAAA and 26AAAB. These provisions were inserted in the Act in 1980 and 1981 respectively, following industrial action by employees working in more remote parts of Queensland. The action was in protest against the Commissioner's intention to use s. 26(e) to tax some part of the value to the employees of subsidised housing provided by their employers. Sections 26AAAA and 26AAAB qualify the operation of s. 26(e) in relation to subsidised housing where a taxpayer who is an employee receives a benefit “in respect of or in relation to his employment . . . by way of the grant of a lease or licence in respect of . . . residential accommodation . . . occupied by the taxpayer or by the taxpayer and his family”. This wording does not cover all forms of subsidised housing. It does not cover circumstances where the benefit relates not to employment but to services rendered. It will not cover a rent allowance. Nor will it cover a direct payment of rent by the employer.

4.54 On its face s. 26AAAA does not change the law expressed in s. 26(e): it merely requires the Commissioner, in determining the value to the taxpayer of the subsidised housing, to have regard to all relevant matters, and to take certain specific matters into account. So far, however, as the specific matters are not relevant to the isolation of the income item or its valuation within the principles just explained, s. 26AAAA must be regarded as having effected changes in the law. Thus the Commissioner is required by para. (b) to take into account the fact that the provision of subsidised housing is customary in the industry concerned. The intention is, apparently, that a fringe benefit which has been enjoyed tax free for a time must continue to be tax free. The difficulty of redressing an inequity in which a substantial number of taxpayers have acquired a vested interest, has already been noted.

4.55 Requiring the Commissioner to take into account the matter specified in para. (d) may have effected a change in the law. It might have been considered that, save where it is a proper conclusion that the enjoyment of high standard or spacious accommodation is a condition of employment, the valuation of that accommodation would not be affected by the fact that the taxpayer was persuaded to enjoy luxury by the circumstance that the employer subsidised its cost. Paragraph (d) would appear to make an
assumption about the meaning of the phrase “value to [the taxpayer]” in s. 26(e), which would assert that luxury has no value to a person who cannot afford it if he must buy it for himself.

4.56 Paragraph (d) of s. 26AAAAA may, however, be read as a matter related to those included in paras (a) and (c). So read, it may not have effected a change in the law. Paragraph (d) requires the Commissioner to take into account the fact that the residential accommodation is of a higher standard than could reasonably be expected to be provided for the taxpayer, or is of a larger size than is necessary to accommodate the taxpayer or the taxpayer and his family. Paragraphs (a) and (c) require the Commissioner to take into account, severally, the fact that the residential accommodation is in a remote area, and the fact that suitable alternative accommodation on reasonable terms and conditions are not available within reasonable distance from the place of employment. Where some of the costs of residential accommodation would be seen as expenses incurred in serving the interests of the employer there is room for treating relief from those expenses as a contribution to capital by the employer. There is no gain by the employee. The relevant principle is that a contribution to capital is not income—Proposition 7. Hochstrasser v. Mayes [1960] A.C. 376 is the case in point.

4.57 Section 26AAAAA(e) does not effect any change in the law. The existence of onerous conditions is clearly relevant to the identifying of the benefit which must be valued.

4.58 The application of s. 26AAAA is excluded if s. 26AAAB applies: s. 26AAAB(9). Section 26AAAB provides that, in certain circumstances, the amount to be included in assessable income by virtue of s. 26(e) is to be 10 per cent of the annual rental value less any rent paid by the employee. An employee must satisfy one of two sets of conditions in order to enjoy the limitation on the amount to be included in assessable income. The first set of conditions relates to geographic remoteness (subs. (1)(a)), and the second relates to the extent to which an employee is required to live in close proximity to his place of work (subs. (1)(b)). While the provision of residential accommodation in the conditions specified might to a degree be explained as a contribution to capital, it is unlikely to extend to 90 per cent of the value of the accommodation. Section 26AAAB thus, at least substantially, gives privileged treatment to certain employees.

4.59 Under s. 26AAAB(1)(a), the section will cover the provision of housing where all the following conditions are met:

(i) the housing occupied by the taxpayer was not at a location in, or adjacent to, an eligible urban area. What is an eligible urban area and what is adjacent to that area
are both defined in s. 26AAAB(10);
(ii) the taxpayer's usual place of employment was not at a location in, or adjacent to, an eligible urban area;
(iii) it was “customary” for employers in the industry concerned to provide subsidised accommodation; and
(iv) in the opinion of the Commissioner it was necessary for the employer of the taxpayer to provide housing for employees for one or more of a number of reasons: the nature of the employer's business was such that employees were liable to be frequently required to change their places of residence; the absence of sufficient suitable housing at or near the place where the employees were employed; and the fact that it was customary for employers in the industry in which the taxpayer was employed to provide subsidised housing for their employees; and
(v) the housing was not provided in pursuance of an agreement not made at arm's length or an agreement that was entered into for the purpose of obtaining the benefit of the section.

It will be noted that the matters of remoteness, custom, an arm's length relationship and absence of an agreement to obtain a benefit are matters of fact. Necessity is a matter of the Commissioner's opinion.

4.60 In contrast with s. 26AAAA, s. 26AAAB(1)(a) closely defines, in s. 26AAAB(10), the areas that will meet a condition of remoteness. Remoteness for purposes of s. 26AAAA is not defined in terms of areas: it is enough that the housing “is situated in a place that is remote from a major centre of population” (s. 26AAAA(a)).

4.61 With respect to s. 26AAAB(1)(a)(iv)(c) it is hard to see how the fact that subsidised accommodation is “customary” can ever necessitate its provision. Perhaps industrial action by the employee taxpayers in support of the custom may make such provision necessary, though it would be odd if tax consequences depended on the propensity to strike. And the fact that a taxpayer employee has demanded the provision of subsidised housing—as opposed to, say, a rent allowance—may raise the inference that the employer and the taxpayer were not dealing with one another “at arm's length” and that the provision of subsidised housing was made “in pursuance of an agreement that was entered into . . . for the purpose, or for purposes that included the purpose, of obtaining for the taxpayer the benefit of the application of [s. 26AAAB]”, in which events s. 26AAAB(1) (a)(v) may operate to deny the limitation on the amount to be included in assessable income otherwise set by s. 26AAAB.

4.62 The other set of conditions which, if satisfied, will attract the operation of s. 26AAAB to limit the amount to be included in assessable income in respect of housing provided by the taxpayer's employer, are set out in s. 26AAAB(1)(b). The conditions, all of which must be satisfied are:
(i) it is customary for employers in the industry in which the taxpayer was employed to provide subsidised housing at or in close proximity to the place or places at which their employees are employed;
(ii) in the opinion of the Commissioner the taxpayer for any of a number of listed reasons had no reasonable alternative to occupying the housing provided by or on behalf of his employer;
(iii) in the opinion of the Commissioner, the conditions under which the taxpayer occupied the housing were onerous by reason that the housing was at or in close proximity to the place at which the taxpayer was employed;
(iv) the employer provided housing for not fewer than five other employees employed at or in association with the place at which the taxpayer was employed; and
(v) the housing was not provided as a result of an agreement not made at arm's length, or an agreement that was entered into for the purpose of obtaining the benefit of the section.

It will be noted that the existence of a custom, the provision of accommodation for not fewer than five other employees, an arm's length relationship and the absence of an agreement to obtain a benefit are matters of fact. The other conditions involve the formation of an opinion by the Commissioner. Again there is an anti-avoidance provision which might be thought to be attracted where there has been industrial action in support of the custom.

**Services and goods provided at a discount**

4.63 The possibility was explored, in [2.15]-[2.16] above, that a right to buy goods or services at a discount might be treated as itself an item of income, as the share options were treated in *Abbott v. Philbin* [1961] A.C. 352 and *Donaldson* (1974) 74 A.T.C. 4192. It is not easy to see why a right to shares is different from a right to goods or services, unless the right to shares gives an interest in the shares. *Abbott v. Philbin* did not, however, insist that the options should give such an interest, if they are to be regarded as an income item. Where the right is to goods or services, the analysis relied on by Lord Denning (dissenting) in *Abbott v. Philbin* is, presumably, appropriate, and there will be a derivation of income at the time of the exercise of the right. That analysis would say that the employee has a contractual right that the employer will maintain an offer to sell to the employee at the promised discount. Such a contractual right is different from the right expressed in an option. The contractual right to buy goods or services at a discount has its parallel in a contractual right that the employer will keep standing an offer to grant options over shares.

4.64 On this analysis of the employee's right to acquire goods or services at a discount, there can, consistent with *Abbott* and *Donaldson*, be a
derivation of income at the time of exercise by the employee of his contractual right. The item of income will be the goods or services obtained by the taxpayer, so far as they represent a gain. They will represent a gain, and will be income, in the amount of the difference between the value of them to the taxpayer, and the amount he outlaid in buying them. If the discount given by the employer is no more than the discount that the taxpayer might have obtained outside the employment relationship, there will be no gain and thus no income.

4.65 The approach taken above, in terms of Lord Denning's analysis in *Abbott v. Philbin*, obviates problems that would arise if the approach adopted were to treat as income the right to the supply of goods or services. However, treating the actual supply of goods or services as the derivation by the employee, must create great difficulties of administration and compliance. Records of the use made of the staff canteen by a particular employee will not be kept, though some record might be available of the use of the executive dining room. Detailed records of “in-house” discounts received by employees of a retail store, are unlikely to be kept. Perhaps, in this case, the discount does not amount to a benefit because like discounts may be available to the employee elsewhere. At some point, however, the equity of the income tax is seriously impaired if discount privileges are ignored. The subsidised travel available to employees in the travel industry may involve substantial benefits. Industrial action is sometimes directed to securing that employees are able to obtain supplies at levels of discount which involve substantial benefits. The assumption is that the availability of such benefits offers an opportunity for tax evasion that will not be challenged.

4.66 *Cooke and Sherden* (1980) 80 A.T.C. 4140 involved an attempt by the Commissioner to bring to tax the value to the taxpayer of a holiday provided without cost. The attempt failed because s. 26(e) was held not to be applicable. The case at once emphasises the inequity that arises from the sole operation of the ordinary usage principle of realisable value and illustrates the need to give s. 26(e) a wider operation.

**Low interest loans**

4.67 The low interest loan is a widely available fringe benefit to employees. It may also be a benefit given in a business situation where, as in Cooke and Sherden, the benefit is not a reward for services. In the latter situation the benefit will go untaxed, assuming that it is not possible for the taxpayer to make the loan available to another person. Where the loan is provided as a reward for services, s. 26(e) is available to the
Commissioner, though fixing the manner of operation of the provision may involve difficulties of analysis.

4.68 Where the loan is for a fixed term and at a fixed rate of interest, it could be argued that there is a derivation of a benefit at the time of the granting of the loan, the amount of income being the present value of the savings of interest apparent on a comparison of the interest charges with those that would have been made for an arm's length loan. If this is the correct operation of s. 26(e) in the fixed-term fixed-interest loan situation, there will be an unacceptable bunching effect. An operation for s. 26(e) which treats the saving of interest as it occurs as the income derived is more convenient. At least in the case of a loan where the lender may vary the interest rate, it is probably the correct operation.

4.69 There is a question of how the saving of interest is to be determined. The fixed-term fixed-interest loan may have been made at a commercial rate. There should not be held to be any benefit in the saving of interest, should the prevailing commercial rate for such a loan increase. Where a fixed-term fixed-interest loan has been made at a rate less than the prevailing commercial rate, there is a benefit by way of saving of interest. But that saving should not be regarded as any more than what may appear from a comparison of the rate set by the loan, and the prevailing commercial rate for such a loan at the time the loan was granted. In such a case there will be some testing of the principle adopted, if the prevailing commercial rate falls below the rate at the time the loan was granted.

4.70 Where the lender has power to vary the interest rate, the interest saving may fairly be regarded as the difference between the rate in fact charged in the year in question by the lender, and the prevailing commercial rate.

4.71 There are evident problems in fixing the relevant prevailing commercial rate. This and the other difficulties adverted to above may indicate that s. 26(e) is not adequate to deal with fringe benefits in the form of interest savings. The difficulties will be multiplied if the financial circumstances of the taxpayer are held relevant to the determination of the “value to the taxpayer”. A taxpayer may assert that he would never have borrowed as much as he did if the low rate of interest had not been offered to him. It may be that there is need of specific provisions to deal with interest savings, provisions that must be arbitrary to a degree.

Goods and services supplied by others and paid for directly by the employer

4.72 An employer may meet directly the expenses of education of an employee's children. There is a benefit derived by the children, but the
circumstances will not give the benefit an income quality in their hands. There may be a benefit to the employee in the form of meeting of expenses which he would otherwise have met himself.

4.73 In some circumstances it will be arguable that there is no income because there is no gain to the employee. The apparent benefit did no more than spare the employee an outgoing he would have incurred in furthering the interests of the employer. The circumstances envisaged would involve the acceptance of employment in a remote place where adequate schooling is not available, on condition that the employer will meet the expenses of boarding the employee's children at school. Any benefit received by the employee could be seen as a contribution to capital within Proposition 7. The relevant authority is *Hochstrasser v. Mayes* [1960] A.C. 376.

4.74 The same analysis might be applied to the direct provision of fares by an employer, where the employee and his family go on home leave from some remote place of employment. It is assumed that there is an agreement with the employee that fares will be provided in this way. A prior agreement assists the characterisation as a contribution to capital, though it may not be essential.

4.75 An employer may meet directly the expenses of the employee's own education, for example in a trade or professional course. Again it is arguable that there is no gain to the employee and the payment by the employer is a contribution to capital. This may involve treating the advantage of education in the way in which the value of a meal is treated where the employee entertains a client of his employer. Any benefit to the employee is seen as a condition of his employment and not a gain recognised by the income tax. The contribution to capital principle has an operation independent of the availability of a deduction to the employee, had he met the expense himself. A want of correlation between a non-income conclusion in regard to the benefit, and deductibility had the employee met the expense himself, suggests tax planning to ensure that the education is paid for by the employer. Section 82A, it will be seen in [8.52] upsets correlation in regard to expenses of an employee's education by requiring that the first $250 of “self education” expenses must be treated as rebatable expenditure (which may not give rise to any tax relief), and is not deductible under s. 51.

4.76 Where the education of the employee furthers not the employer's purpose but the purpose of the employee, there will be income to the employee by the operation of s. 26(e). Where there is only an incidental element of employee's purpose, the predominant purpose of the payment should govern, in line with the view that the characterising of a benefit as a product of employment should follow its predominant purpose. Section
82A aside, correlation with the treatment of expenses incurred by the employee himself is probably preserved by a principle whereby the whole of self-education expenses must be subject to a single characterisation as deductible or not deductible, and, despite the words “to the extent to which” in s. 51, no apportionment is proper. That principle excludes an apportionment where there are two purposes served by an expense and a distinct payment could not have been made to serve each purpose. It is considered in [6.28], [8.16], [8.51], [8.85] and [9.11] below.

4.77 An employer may meet directly the travel and entertainment expenses of his employee. The appropriate treatment of any benefit to the employee would follow the analysis just attempted in regard to self-education expenses. The benefit of travel or entertainment may be a condition of employment.

4.78 Section 51AB was added to the Assessment Act in 1974. Its effect is to deny a deduction to the employer, of expenses to secure or maintain the membership of a club for an employee, and of some like expenses. The section will deny a deduction by the employee where he meets the expenses himself. The operation of the section where the employer meets the expenses may be to deny a deduction to the employer, and yet leave the employee subject to tax on the ground that there is a benefit to him which is income under s. 26(e).

**Moneys made available to employees for travel and entertainment expenses**

4.79 Where money is made available to an employee on condition that he vouch his expenses and return any surplus, the money should be treated in the same manner as the direct provision of travel and entertainment would be treated. Where the travel and entertainment are predominantly in serving the employer's purposes, there is no gain to the employee: the money is a contribution to capital. A reimbursement of such expenses would be treated in the same manner. It may be argued that the money is an “allowance”, and is made income by s. 26(e). The argument in reply is that the word should be given the meaning that it has in the context of the other associated words in s. 26(e)—“gratuities, compensations, benefits, bonuses and premiums” (*Mutual Acceptance Co. Ltd* (1944) 69 C.L.R. 389, per Dixon J. at 402–403). In that context money provided subject to obligations to vouch, and if necessary refund, is not an allowance. The expenses of the employee in these circumstances will not be outgoings within s. 51(1) and no question of deductibility will arise.

4.80 Where money is given, but vouching and return of surplus are not required, the money is an allowance that is income. The employee may be
entitled to deductions which will produce the same result, in terms of taxable income, as in the cases of an allowance subject to vouching and return of surplus, and direct provision of travel and entertainment.

Section 26(ea): fringe benefits of a member of the Defence Force

4.81 Section 26(ea) has provisions, relating to a member of the Defence Force, which parallel some of the provisions of s. 26(e). It would appear to be a survival in part of an earlier provision that included a proviso by which a money limit was imposed on the value of allowances in kind “that would be income”. As it now stands, s. 26(ea) has no function that is not performed by s. 26(e), unless it is construed to extend in its operation to amounts excluded from the operation of s. 26(e) by subparas (i) and (ii) of s. 26(e). Section 26(ea) does not, in terms, except an eligible termination payment within the meaning of Subdiv. AA of Div. 2 of Pt III, or an amount to which s. 26AC or s. 26AD applies. There is left a question of the correlation between s. 26(ea) and those provisions. A correlation might be achieved by limiting the meaning of “allowances” in s. 26(ea), but the meaning for the word that would achieve this result is not evident. Another correlation would involve treating Subdiv. AA and ss 26AC and 26AD as codes that displace s. 26(ea).

Section 26AAC: reward for services in the form of shares or rights to shares

4.82 Section 26AAC has already been the subject of comment in [2.25], [2.35], [4.20]–[4.21] above. Where the section applies, s. 26(e) is excluded. The section concerns rewards for services, but it does not adopt the test of “value to the taxpayer” provided for in s. 26(e).

4.83 There are some consequences. Where an option is acquired, under a scheme of the kind with which the section is concerned, and it is disposed of to a person who is not an associate of the taxpayer, there is an item of income derived by the taxpayer in the amount of the consideration received, less the amount paid or payable by the taxpayer as consideration for the right. If s. 26AAC had not been applicable, the value to the taxpayer of the option at the time of the grant of the option would have been income. The amount may have been more than the amount realised on the disposition of the option. Where the employee has acquired shares under the scheme, their “value”, less the costs of the taxpayer’s acquisition of the shares, will be income. This value will be determined at the time the shares cease to be subject to restrictions or are disposed of by the taxpayer. “Value” for this purpose may differ from “value to the taxpayer” under s. 26(e), for reasons not concerned with the differences in times of derivation.
How much the difference in value may be, in each of the circumstances referred to, will depend on the extent of the restrictions affecting the options or continuing to affect the shares at the time of disposition. It will also depend on the taste and economic circumstances of the taxpayer, and any special knowledge have, if those factors are relevant in fixing a “value to the taxpayer”.

Character of an item Judged in the Circumstances of its Derivation by the Taxpayer: Proposition 3

4.84 From the discussion of s. 26(e) above, it will be evident that s. 26(e) does not depart from the principle that the character of an item as income must be judged in the hands of the person who derived it. Section 26AAC (1)(b) does depart from the principle. More important are the departures from the principle made in Div. 6 (Trusts) and Div. 9B (Superannuation funds) of Pt III.

Section 26AAC(1)(b): income character of shares derived by a taxpayer determined by the character they would have in the hands of a relative of the taxpayer

4.85 Section 26AAC applies in relation to the acquisition of a right to shares, or to the acquisition of shares, by a person under a scheme for the acquisition of shares by employees. The person who acquires may derive income, notwithstanding he is not the employee who has furnished the consideration by rendering services. By section 26AAC(1)(b), it is enough that a relative of the person who acquired the right or the shares performed the services.

Division 6 of Part III: The income character of receipts by a trust entity determined by reference to the circumstances of a hypothetical person

4.86 The operation of Div. 6 in applying special notions of derivation has already been explained in [4.26]–[4.30] above. The income quality of what is imputed as derived by a beneficiary, because of his “present entitlement” to what is income by trust law, or the income quality of what is imputed as derived by the trustee because of the want of derivations by beneficiaries, is determined by reference to the circumstances of the hypothetical taxpayer referred to in s. 95—the trustee “as if he were a taxpayer”. The definition of “net income” in s. 95 calls for a calculation of income and the subtraction of deductions, made on the assumption that the trustee is a taxpayer. Sections 97–99A provide for the imputing of derivations of that
net income by beneficiaries in proportions determined by their interests in
trust law income, and, as to any surplus, the imputing of derivation by the
trustee in his capacity as trustee. The income quality of what is imputed as
derived by beneficiaries and trustee is determined by the circumstances of
the person who is the trustee “as if [he] were a taxpayer”. The hypothesis
might have been expressed in the words “as if [he] had derived
beneficially”. The hypothesis thus supplies the element of gain that is
identified in Proposition 4 as a necessary requirement for an item to be
income. Section 95 does not, however, attribute to the hypothetical person
the qualities the trustee has in his own right. Thus it will be seen in [13.74]
ff. below that where the trustee of a share in a partnership is in his own
right a partner but not a trustee, the character of partner is not attributed to
the hypothetical person.

4.87 The circumstances of derivation by the beneficiary under s. 97 or s.
98, or by the trustee under ss 99 or 99A, need not be examined for aspects
which would give what is derived the character of income in his hands.
Those circumstances might in fact give an income quality, for example, to
interest or rents to which the beneficiary has an immediate beneficial
entitlement, or to a receipt by a beneficiary under an annuity which the
trustee is bound to pay. But they would not in general give an income
quality to a distribution made by the trustee to a beneficiary in the exercise
of a discretion given to the trustee.

4.88 Where the circumstances of derivation by the beneficiary would not
give an income quality to what is derived, or where there is no derivation
by a beneficiary, Div. 6 has the effect of bringing to tax gains which would
otherwise go untaxed. Div. 6 should therefore not be given a narrow
operation. Some observations in the Federal Court in Everett (1978) 78
A.T.C. 4595 may suggest that the words “trust estate” in s. 95 require that
there should be property vested in the trustee from which the gains are
derived, if they are to be brought to tax under the Division. The view was
expressed above in [2.233] that the reference to “trust estate” should be
regarded as a reference to a tax accounting entity which transcends the
person who may be trustee for the time being. The word “estate” is not
used in any sense which requires that property be vested in the trustee. But
the gains derived by the trustee must be derived in circumstances which
would give them an income character if they were derived by the trustee
beneficially. Under an assignment of a mere expectancy, if it is effective,
the assignor becomes trustee of the item assigned when it comes into
existence. The assignment may be of future salary. The assignor becomes
trustee of a present right to receive salary when that right comes into
existence. He is trustee for the assignee. The arising of the trust is a
constructive receipt, within ordinary usage notions of derivation, or s. 19, by the assignor, so that the salary is at that moment his income. But the salary will not be income of the hypothetical person—the trustee, in this case the assignor, as if he were a taxpayer—about whom the s. 95 calculation is made. The assignor has not, as trustee, performed services which would give an income quality to his receipt as trustee. His receipt as trustee is a receipt of corpus. The matter is further considered in [13.9]ff. below.

4.89 On the other hand, services performed by a trustee as trustee, for example in carrying on a business included in the estate of a deceased person, will give an income character to a receipt which is a reward for those services when the calculation required by s. 95 is made.

4.90 Section 101A, in the special circumstances of a receipt by a trustee of the estate of a deceased person of “any amount which would have been assessable income in the hands of the deceased person if it had been received by him during his lifetime”, requires that the amount be treated as income derived by the hypothetical person about whom the s. 95 calculation is made. The amount will fall to be taxed under s. 99 or s. 99A.

4.91 The combined operations of s. 101A and s. 95, in relation to the requirement that income quality must be judged in the hands of the person who derives, become complex. Section 95, for purposes of the calculation required by that section, supplies the element of beneficial derivation. Section 101A supplies other elements which may give the character of income to the receipt, by imputing to the trustee's derivation the circumstances that would have attended a derivation by the deceased. The extent of this imputation remains a matter of some doubt. Where the deceased had at the time of his death taken all the action that would have brought about an income derivation by him had the final element of derivation been satisfied, s. 101A must operate to impute all that action to the trustee. But where some action is taken by the trustee or by other persons—for example, the partners of the deceased as in Single (1964) 110 C.L.R. 177—there is a question whether that action may be added to the action imputed to the trustee. Where the action taken by the trustee is itself enough to supply circumstances which will give an income quality to the receipt by the hypothetical person in s. 95, there will be income for purposes of s. 95 without the aid of s. 101A. Where it is not, the question is whether the action taken by the deceased and the action taken by the trustee may be added together. Where the further action is taken by other persons, for example partners of the deceased who complete a matter uncompleted at the time of death, a like question arises. These matters are further considered in [11.66]ff. and [11.150]ff. below.
4.92 Section 99B stands outside the general operation of Div. 6. Subject to some qualifications, it gives an income quality to a derivation of property of a trust estate by a beneficiary, the derivation being a payment to him of that property, or an application of it for his benefit. The qualifications involve some logical impossibilities which courts will need to tolerate. Thus, one qualification excludes an amount “that is or has been included in the assessable income of the beneficiary in pursuance of s. 97”. It has been explained above that what is income derived by a beneficiary under s. 97 involves an imputed derivation of part of an amount that is derived by the hypothetical person in s. 95. This imputed derivation calls on the actual entitlement of the beneficiary to trust law income of the trust, in fixing the part of the amount derived by the hypothetical person that is to be imputed. It is only by some breaking through the barriers of logic, that property in fact paid to a beneficiary by the trustee can be said to represent an amount included in the income of the beneficiary under s. 97.

Division 9B of Part III: income character of receipts by a superannuation fund or an ineligible approved deposit fund

4.93 Division 9B, in providing for the taxing of the receipts of superannuation funds and ineligible approved deposit funds, as defined in s. 121B, in the hands of the trustees of those funds, uses the same technique as Div. 6. Division 9B was considered above in [1.16]–[1.23]. The element of beneficial receipt which will give the quality of income to receipts by the trustee which are otherwise income, is supplied by the hypothesis that the trustee is a taxpayer. The relevant provisions are s. 121B in the definition of “investment income”, s. 121D, s. 121DAA and s. 121DAB. These provisions are further considered in [4.166]ff. below. One observation might be made here. In defining “investment income”, s. 121B expressly excludes contributions to the fund. It thus appears to assume that contributions to a superannuation fund will be income of the hypothetical person. The only relevant positive principle would be the periodical receipts principle (Proposition 11), but that principle would not be thought to be satisfied.

4.94 In any case, the hypothesis that the trustee derives beneficially does not deny the actual obligations on the trustee imposed by the contributor in making the contribution, obligations which attract the contribution to capital principle (Proposition 7) and deny any income quality that might otherwise have been given by the periodical receipts principle.

Gain as an Essential Quality of Income: Proposition 4
Section 27H: annuities, pensions and supplements to pensions

4.95 The prospect that the periodical receipts principle, and, indeed, the gains from property principle and the compensation receipts principle, may in their operations defeat the principle that gain is an essential quality of income has been raised on a number of occasions in this Volume. The operation of the undeducted purchase price provisions of s. 27H in achieving some saving of the principle from that defeat is considered in [2.215] above and [4.106]ff. below.

Divisions 6 and 9B of Part III: the requirement of gain in the circumstances of derivation by a trust entity

4.96 The provisions of Div. 6 (trusts) and Div. 9B (superannuation funds and ineligible approved deposit funds) considered under the last heading ([4.86]-[4.94] above), involve tax to a trustee on an amount which does not involve gain. In the case of a trust which is not a superannuation fund or deposit fund, there is income of the trustee as trustee to the extent of the whole or part of the amount calculated as provided in s. 95 on an assumption that the trustee derives beneficially. The amount of income of the trustee is the amount remaining after allocations of the s. 95 amount to beneficiaries who have present entitlements to trust law income, or have deemed present entitlements by the operation of s. 95A(2) or s. 101. The operation of Div. 9B is considered in [4.166]ff. below and in [1.10]-[1.23] above.

Sections 119 and 121: the exclusion of the requirement of gain by excluding the mutuality principle

4.97 In the treatment of the principle of mutuality in [2.45]ff. above the effect of ss 119 and 121 in displacing that principle is explained. Section 119 makes income certain of the receipts of a co-operative company as defined in s. 117. Section 121 makes income premiums derived by an association formed for the purpose of insuring members of the association “against loss, damage or risk of any kind in respect of property”. To the extent that the principle of mutuality would otherwise have applied to these receipts and premiums, ss 119 and 121 displace the principle that gain is an essential quality of income. The principle of mutuality is a particular application of the principle of the ordinary usage meaning of income that asserts that gain is an essential quality of income.

Section 26(g): bounties and subsidies
4.98 The possible effect of s. 26(g) in extending the ordinary usage meaning of income, so as to displace the negative proposition that a contribution to capital is not income, is the subject of comment in [2.131] above.

**Mere Gift does not have the Character of Income: Proposition 8**

Sections 26(e) and 26(g): receipts in a service relationship, bounties and subsidies

4.99 Two provisions of the Assessment Act—ss 26(e) and 26(g)—might have been given a construction that would have extended the ordinary usage meaning of income so as to displace, in some degree, the negative proposition that a “mere” gift does not have the character of income.

4.100 Section 26(e) might have been construed to include gains associated with the performance of services which are not, within the ordinary usage notion, “products” of those services. The discussion of s. 26(e) in [2.367] above and in [2.373] above indicates that the section has not been given such a construction.

4.101 Section 26(g), which relates to “any bounty or subsidy received in or in relation to the carrying on of a business”, could be construed so as to include gains related to the carrying on of a business which bear a more tenuous relationship than is required by the ordinary usage notion of income, which extends only to items which are products of the business as illustrated in *Squatting Investment Co. Ltd* (1954) 88 C.L.R. 413. There is no decision that it will be so construed. The construction of s. 26(g) is the subject of some observations in [2.131].

**A Capital Gain does not have the Character of Income: Proposition 10**

Sections 25A and 26AAA: Profits from some sales and profit-making schemes, and from sales of property within 12 months of purchase

4.102 The effect of s. 25A and s. 26AAA in displacing to a degree the negative proposition (Proposition 10) which sets, in some respects, the scope of the principles which make up the ordinary usage meaning of income, was referred to in [2.166]-[2.171] above. Those sections are the subject of close examination in Chapter 3 above.

Sections 26AAB, 59, 60, 122K, 123C, 124AM, 124G, 124JB, 124P: receipts that recoup capital expenditures that are allowable deductions
4.103 In a number of its provisions the Assessment Act allows deductions for what is capital expenditure which would not be deductible under s. 51, in respect of the cost of property used in producing income. Thus the depreciation provisions, ss 54–62, allow deductions in respect of expenditure on items which are plant or articles used for the purpose of producing income, plant for this purpose including certain structural improvements. Other provisions are concerned with capital expenditure in general mining activities (Div. 10 of Pt III), capital expenditure in relation to the transport of certain minerals (Div. 10AAA of Pt III), capital expenditure in relation to petroleum mining (Div. 10AA of Pt III), capital expenditure in respect of timber operations (Subdiv. A of Div. 10A of Pt III), capital expenditure in respect of timber mill buildings (Subdiv. B of Div. 10A of Pt III) and capital expenditure in respect of commercial or industrial property (Div. 10B of Pt III). In all these provisions there will be found a section which is directed to bringing in as income an amount received on disposal of the item of property, so far as the amount exceeds the capital expenditure after subtracting the amounts that have been allowed or were allowable as deductions. In a sense these sections extend the concept of income under the Act into the field of capital gains. But their function is only to reverse the allowance of the deductions, where the expenditure has been recouped by the consideration received on disposal. The sections are confined to this function by express provisions which limit the amount that is income to the amount of the deductions allowed or allowable. To the extent that the consideration received on disposal exceeds the capital expenditure, it cannot be income. The sections which provide for bringing in consideration received on disposal are s. 59 (depreciation provisions), s. 122K (general mining), s. 123C (transport of minerals), s. 124AM (petroleum mining), s. 124G (timber operations) and s. 124P (commercial or industrial property).

4.104 Section 26AAB, inserted in the Act in 1980, in its terms makes income a profit on the sale of a motor vehicle which has been the subject of a lease to the taxpayer or his associate, and has been acquired by the taxpayer from the lessor. The profit—the difference between the cost on the acquisition and the consideration receivable in respect of the disposal—would in many instances be a capital gain, and the section thus, on its face, extends the concept of income under the Act into the field of capital gains. The function of the section, like the function of the other sections referred to in the last paragraph, is, however, only to reverse the allowance under s. 51 of deductions for charges paid by the lessee under the lease where those charges have been recouped by the profit on the acquisition and disposal of the item. Section 26AAB(2), in the calculation of the amount of the profit
that is income, confines the function of the section in this way.

4.105 To the extent that the section makes income what is a recoupment of a deduction allowed not to the taxpayer, but to an associate as defined in the section, there is some departure from the principle of the ordinary usage meaning that the quality of income must be judged in the circumstances of its derivation by the taxpayer.

**Periodical Receipts: Proposition 11**

*Section 27H: annuities, pensions and supplement to pensions*

4.106 Attention has already been directed, in [2.215]-[2.223] above, to the contributions. Section 27H, in its deductible amount provisions, may make to protecting the principle that gain is an essential quality of income, and to the problems that may arise in identifying the “undeducted purchase price” from which the deductible amount will be calculated. Attention has also been directed to the question of correlation between the provisions of s. 27H and the periodical receipts principle. That problem has been made more difficult by the words added to s. 25(1) in 1984, from which an inescapable conclusion must be drawn that s. 27H cannot displace the ordinary usage principle of periodical receipts. The consequence would be that the deductible amount by which the amount of an annuity that is taxed under s. 27H is reduced, is income subject to tax as ordinary usage income under the periodical receipts principle.

4.107 There are other problems of correlating the provisions of s. 27H and the business receipts principle. In this instance a conclusion that s. 27H does not displace the ordinary usage principles would be accepted. A person who is engaged in a business of dealing in mining rights may sell mining rights for amounts to be paid periodically in respect of each ton of ore obtained in working the mining rights during a fixed period of years. The amounts, it is assumed, are income as an annuity. The business receipts principle would direct that the proceeds of sale, less the cost of the mining rights, are income. Section 27H would direct that the annuity receipts are income as each is received less an appropriate part of the purchase price of the annuity, which, in this instance, would be the value of the mining rights—not their cost—at the time of their sale for the annuity receipts. There are tax accounting problems in relation to the operation of the business receipts principle in this context. One question would be whether the trading stock provisions apply, in which event *J. Rowe & Son Pty Ltd* (1971) 124 C.L.R. 421 would be relevant though it would not dictate the method of accounting. If the mining rights are not trading stock,
profit accounting would be applicable. But whatever method of accounting were applicable, there is no obvious way of correlating the business receipts principle and s. 27H, except by denying the operation of the section. There could be room for s. 27H only if the transaction is regarded as two transactions: a sale of the mining rights for the value of the annuity, and the application of that value in the purchase of the annuity. There would be like problems of correlation if the mining rights had been acquired and sold in circumstances that attracted the operation of s. 25A(1) or s. 26AAA.

4.108 The deductible amount provisions of s. 27H, taken with the definitions of “undeducted purchase price” and “purchase price” in s. 27A(1), are more complex than the provisions of s. 26AA which s. 27H replaced. The “purchase price” in relation to a pension payable from a superannuation fund (which is an annuity for purposes of s. 27H) is the sum of contributions made by any person to the superannuation fund—which will include contributions by an employer of the taxpayer—to obtain superannuation benefits consisting only of the superannuation pension, and so much as the Commissioner considers reasonable of contributions made by any person to the superannuation fund to obtain superannuation benefits including the pension payable from the fund. In relation to an “eligible annuity”, which includes any immediate annuity not payable from a superannuation fund, the purchase price is the sum of payments made solely to purchase the annuity, and so much as the Commissioner considers reasonable of payments made to purchase the annuity and to obtain other benefits. There is no definition of purchase price for purposes of a deferred annuity unless it is a “roll-over annuity”—one purchased in the rolling-over of an eligible termination payment by the exercise of an election given to the taxpayer by s. 27D—or an annuity payable under a superannuation policy within the meaning of Div. 8.

4.109 The definition of “undeducted purchase price” must be read against a background of other provisions of Subdiv. AA of Div. 2 of Pt III, more especially ss 27B, 27C and 27D examined in [4.138]ff. below. It will be noted that the definition of “undeducted contributions”, the comparable provision concerned with the operation of ss 27B and 27C which tax distributions from superannuation funds that are not annuities, does not extend to contributions before 30 June 1983. The “undeducted purchase price” definition does not make separate provision in regard to the purchase price of a superannuation pension and the purchase price of another annuity. It is only by recalling the distinction drawn in the definition of “purchase price” that the appropriate areas of operation of the definition of undeducted purchase price can be determined. Thus the
“undeducted purchase price” of an annuity purchased by the roll-over under s. 27D of some part of the amount of an eligible termination payment is not confined to the contributions made to the superannuation fund in respect of the distribution that is rolled over. The undeducted purchase price is the amount rolled over, though under s. 27D the taxpayer might specify that his roll-over is of that part of the eligible termination payment that represents the undeducted contributions to the fund.

4.110 One common thread in the undeducted purchase price provisions and in the undeducted contributions provisions, is that the purchase price or contributions must not be allowable deductions. In the case of contributions to a superannuation fund or a purchase price of an annuity, paid prior to 1 July 1983, there is a further requirement that the contributions or purchase price must not be rebatable amounts under s. 159N or be amounts in respect of which a rebate of income tax has been allowed.

4.111 The undeducted purchase price of an annuity acquired by payments that involve the roll-over of the whole or part of an eligible termination payment cannot include an amount rolled over that would have been taxed under s. 27B if there had not been a roll-over. Such an amount will not include the undeducted contributions in respect of that amount. Undeducted contributions are excluded by s. 27B(1) from the amount taxed under that section. The amount of the undeducted contributions may itself be rolled over under s. 27D, and there may be distinct roll-overs of amounts that would otherwise be taxed under s. 27C(1), and “concessional components” that would otherwise be taxed under s. 27C(2). In all instances other than an amount that would have been taxed under s. 27B had there not been a roll-over, the amount rolled over will be the “undeducted purchase price” of the annuity.

Section 262: periodical payments which in the opinion of the Commissioner are really in the nature of income

4.112 A possible operation of s. 262 which would give the Commissioner power to attribute the quality of income to “periodical payments” was considered in [2.224]-[2.225] above.

Gains Derived from Property: Proposition 12

Section 26AB: Premiums that relate to the grant or assignment of a lease

4.113 The effect of s. 26AB in providing that a premium is income in specified circumstances is considered above in [2.302]–[2.308]. The view
expressed is that s. 26AB does not deny the character of income to a premium in other circumstances, if it would be income within the ordinary usage principles either as a gain derived from property or as a business gain.

Section 26(f): an amount received as or by way of royalty

4.114 The meaning of royalties as the word is used in s. 26(f), and the effect of that provision in possibly extending the meaning of income in the Act beyond the ordinary usage notion of income derived from property, is the subject of comment in [2.309]–[2.366] above.

4.115 At the time of the decisions in McCauley (1944) 69 C.L.R. 235 and Stanton (1955) 92 C.L.R. 630 the Assessment Act contained no definition of “royalty”. Those cases proceeded by the fixing of a meaning for the word royalty and an examination of the facts to see if the amounts derived were within that meaning. Whether the amounts might be income as income derived from property, within the ordinary usage meaning of income, was not considered. Nor was any consideration given to the question whether the effect of s. 26(f) is to extend the meaning of income beyond ordinary usage.

4.116 The meaning given to “royalties” in s. 26(f) unaided by any definition would not appear to take the meaning of income under the Act beyond its ordinary usage meaning. However, Mason J. in Sherritt Gordon Mines Ltd (1977) 137 C.L.R. 612 at 626 appeared to be of the view that “royalties” covers payments by the owner triggered by the use by the owner of property that has been wholly transferred to that owner. It is not finally settled that such payments are income of the transferor within the ordinary usage meaning of income derived from property, though the view taken in this Volume would be that they are. There remains the possibility that the phrase “by way of royalties”, as distinct from the phrase “as royalties”, may give an extended meaning to income. But there is no decision on the effect of that phrase other than Stanton, which must be taken to have decided that the receipts there in question were neither receipts “as royalties” nor “by way of royalties”. Sherritt Gordon Mines Ltd (1977) 137 C.L.R. 612 is a decision on the meaning of the word “royalty” in the phrase “consists of royalty” in s. 6C. It does not offer any assistance in deciding when an item may be said to be received “by way of royalties”. Aktiebolaget Volvo (1978) 78 A.T.C. 4316 is also a decision on the meaning of the word in the phrase “consists of royalty”. It does not decide that the receipts there in question could not be said to be receipts “by way of royalties” and thus income under s. 26(f). The phrase “by way
of royalties” may extend the operation of s. 26(f) so that it includes receipts triggered by the use of know-how supplied to the payer, as in *Sherritt Gordon Mines*, or receipts triggered by the exercise of a right where the whole bundle of rights of which it is a part have been acquired from the taxpayer by the payer. In neither case, however, would s. 26(f) appear to have extended the meaning of income beyond the ordinary usage notion of income derived from property. The view taken in [2.352]–[2.355] above is that receipts triggered in these ways are within the ordinary usage meaning of income.

4.117 Since the decisions in *Stanton* and *Macauley* a definition of “royalties” has been added to the Assessment Act. As at first drafted the definition was held, in *Sherritt Gordon Mines*, to have a narrow meaning resulting from the fact that the definition involved an incorporation by reference from the United Kingdom-Australia double tax agreement. As re-drafted, and after further re-drafting in an endeavour to overcome interpretation by Jenkinson J. in *Aktiebolaget Volvo*, the definition extends the meaning of the word “royalties” so that it embraces items which would not otherwise be regarded as described by the word, though it might be thought to remain inadequate to overcome what Jenkinson J. saw as a deficiency in the drafting: it does not cover an item that has accrued but has not yet been either paid or credited. The matter is considered in [4.13]–[4.14] above. It should be noted that the definition does not when taken with s. 26(f) make any item income that would not otherwise be income. Section 26(f) is drafted so that items received as or by way of royalties as defined, which are not received as or by way of royalties as the word is interpreted in *McCauley, Stanton* and *Sherritt Gordon Mines*, are not within the operation of s. 26(f), unless they are income by ordinary usage.

4.118 How far the items listed in the definition of royalty in s. 6 are income by ordinary usage will depend on the principles explored in dealing with Propositions 11 (periodical receipts), 12 (gains from property), 13 (rewards for service), 14 (business gains) and 15 (compensation gains). Where a payment or credit is one of a series, the item is more likely to be income. The definition, however, extends to items “whether the payment or credit is periodical or not”. A single sum for an exclusive licence giving the “right to use” a “copyright, patent, design or model, plan, secret formula or process, trademark, or other like property or right”, is included by para. (a) of the definition. Such a sum will not be income by ordinary usage unless the taxpayer receiving the sum is in business, and the copyright or other property or right is a revenue asset of the business, or the method of calculation of the single sum is such that it is to be regarded as paid for the use of the copyright or other property or right. A single sum for “the right
“industrial, commercial or scientific equipment” is included by para. (b) of the definition. Such a sum may be seen as a premium for the property itself, and it will not be income if there is no operation of the business gains principle. Paragraph (c) of the definition covers a single sum “for the supply of scientific, technical, industrial or commercial knowledge or information”. Such a sum may be income in circumstances suggested by the decision in *Rolls-Royce v. Jeffrey* [1962] 1 W.L.R. 425 and explored in [2.361] and [2.490]–[2.491] above. A single sum for the supply of assistance referred to in para. (d) may be income as a reward for services. Paragraph (e), which will cover a single sum for the right to use motion picture films and like items of property, raises questions parallel with those raised by para. (a).

**4.119** Paragraph (f) was added to the definition following *Aktiebolaget Volvo* (1978) 78 A.T.C. 4316. It will be recalled that Jenkinson J. declined to express a view on whether the receipts were income, though in that case the receipts were in a series. The inference from *Moriarty v. Evans Medical Supplies Ltd* [1958] 1 W.L.R. 66 and *Murray v. I.C.I. Ltd* [1967] Ch. 1038 is that a lump sum received for a keep-out covenant is generally not income. There may be some prospect that it is income as a reward for services, but it may be doubted that it would be so regarded where the effect of the keep-out covenant is to leave the person in whose favour the covenant is given effectively with the exclusive use of property.

**4.120** The principal function of the definition in s. 6 is to expand the items given an Australian source by the operation of s. 6C. That section applies to “income” that “consists of royalty”. Section 6C has no function to make any item income.

**Section 26(i): any amount received as or by way of bonus**

**4.121** Section 26(i) makes income “any amount received as or by way of bonus other than a reversionary bonus on a policy of life assurance”. There is no judicial interpretation of the word “bonus” where first used in s. 26(i). If it refers to a bonus in the sense of additional remuneration paid to an employee, the paragraph confirms the ordinary usage principle in relation to rewards for services, and repeats the confirmation in s. 26(e). The word clearly includes a bonus in the sense of a payment before maturity to the holder of a life insurance policy. The operation of s. 26(i) in this regard would confirm the ordinary usage principle in regard to gains derived from property.

**4.122** The exclusion of a reversionary bonus on a policy of life assurance raises several questions. “Reversionary bonus” may refer to a bonus which
is payable only on the maturity of the policy. Such a bonus, though added during the currency of the policy to the sum assured, would not be income under the gains from property principle until maturity of the policy and receipt by the taxpayer. Section 26(i) may have the effect of excluding such a bonus from income when received in money on maturity. It will have this effect if the paragraph is interpreted in the manner adopted by the majority in Reseck (1975) 133 C.L.R. 45 in relation to s. 26(d). The question of the effect of the words added to s. 25(1) in 1984 is, however, raised. Section 26(i) could not exclude from income an amount that is expressly made income by the provisions of s. 26AH, a section added to the Act in 1984 but prior to the addition of the words to s. 25(1). Section 26AH makes income specified fractions of bonuses received under a life insurance policy within 10 years of the commencement of the risk under the policy. Section 26AH appears to proceed on the assumption that a bonus has been excluded from income by s. 26(i)—presumably an immediate cash bonus or a reversionary bonus. That assumption could hardly be justified in regard to an immediate cash bonus. The question of the effect of s. 26AH in regard to a cash bonus will also depend on the consequences of the words added to s. 25(1). The combined operation of s. 26(i) and s. 26AH, taken with the words added to s. 25(1), is beyond any rational resolution.

4.123 “Reversionary bonus” may also include a bonus which may be redeemed prior to maturity. The bonus will normally be redeemable in this way by a payment to the policy holder of an amount less than the amount payable as bonus on maturity. Such a bonus, if redeemed, would be income when redeemed under the ordinary usage principle. If s. 26(i) extends to such a bonus, it may have the effect of excluding the bonus from income whether received in money during the currency of the policy, or on maturity. It will have this effect if the paragraph is interpreted in the manner adopted by the majority in Reseck in relation to s. 26(d). Again, however, the question of the effect of the words added in 1984 to s. 25(1) posed in [2.223], [2.369] and [4.5] above is raised.

Section 26(1): Payment for non-compliance with a covenant to repair

4.124 The background to s. 26(1) is in the decision of the High Court in Peyton (1963) 109 C.L.R. 315, in which it was held that a particular payment by a lessee on the transfer of his lease was not deductible. The payment was the estimated cost of work to carry out repairs which the lessee was bound to effect in order to obtain the consent of the lessor to the assignment. The lease provided that if the lease was transferred before the
repairs were effected, the lessee would pay the estimated cost of the repairs to the lessor. The High Court held that the payment was not deductible. It said (at 321):

“But according to the terms of the proviso he became liable to pay the amount upon the licence being transferred, that is to say upon and by reason of the final event in the process by which he ceased to be concerned in the business he had been conducting on the premises. He incurred the loss or outgoing, therefore, not in gaining or producing the assessable income but in parting with the means by which he had been gaining and producing it; not in carrying on the business for the purpose of gaining or producing such income, but in disposing of the business and ceasing thereby to gain or produce such income.”

4.125 The Act was amended in 1963 by the addition of s. 53AA so as to allow a deduction where a payment is made by way of indemnity, compensation or damages in respect of an obligation to effect repairs. The section operates in circumstances wider than those of Peyton. Section 26(1) is intended to ensure that an amount “referred to in s. 53AA” is income of the grantor of the lease, or of a successor in title.

4.126 Section 26(1) may be necessary to ensure that the receipt by the lessor is income where the circumstances are those in Peyton. The receipt is in effect a price of the lessor's consent to the assignment of the lease, and may be regarded as a premium. The question whether a premium is income is considered in [2.297]–[2.308] above.

4.127 Where the receipt is during the running of the lease and is compensation for the failure of the lessee to effect repairs, it could have the character of income without the aid of s. 26(1) as compensation for an income item in the nature of rent, being the value of the repairs the lessee has undertaken to effect. There may be a general assumption that the value of repairs effected by a lessee under the terms of a lease is not income of the lessor, but it is an assumption for which there is no judicial authority. The determination of the value of the repairs would present problems. Section 26(e) is not applicable and the measure must be realisable value. It is a mark of uncertainty in this area that Div. 4 of Pt III, now of very limited operation, made covenanted improvements by a lessee income of the lessor, but only in the amount of their value at the conclusion of the lease.

**Subdivision D of Division 2 of Part III and sections 108, 109: dividends as defined and deemed dividends**

4.128 Sections 44–47 contain a number of provisions by which distributions made by a company, whether as a going concern or in
liquidation, are income of its shareholders. The interpretation of those provisions was examined in [2.235]–[2.269] above. Until amendments made in 1967, the courts had tended to limit the effect of the provisions by reading them in a way which would leave them as far as possible consistent with what was thought to be the ordinary usage meaning of income. Thus, in Uther (1965) 112 C.L.R. 630, a receipt by a shareholder in a reduction of capital where the amount received exceeded the amount of capital reduced, was held not to be income in any part under s. 44. The section was held not to make income what was, in ordinary usage language, not a gain derived from the share, but a receipt in partial realisation of the share itself.

4.129 Sections 44–47, as now drafted, may have effectively excluded these limitations by writing out of the sections any continuing assumptions drawn from the ordinary usage meaning of income.

4.130 There may, none the less, be room for continuing independent operation of the ordinary usage meaning of income in giving content to the meaning of income under the Act. The question raised is whether Subdiv. D is a code, and as to the scope of that code. The question of the effect of the words added to s. 25(1) in 1984 posed in [4.5] above is, however, again raised. While the added words remain, Subdiv. D cannot be interpreted so as to make it a code.

4.131 Section 108 deems certain payments or assets distributed by a private company to be dividends paid by the company to the extent that, in the opinion of the Commissioner, they represent distributions of income. Section 109 deems sums paid or credited by a private company to be dividends where they are paid or credited to a person who is or has been a shareholder or director of the company, or a relative of a shareholder or director, if they are by way of remuneration for services, or they are retirement allowances. They will be deemed dividends to the extent that, in the opinion of the Commissioner, they exceed an amount that is reasonable.

4.132 The sections are probably intended to deal with the character of the items both in relation to deductibility by the company and in relation to whether they are income of the person receiving the payment. But there are deficiencies in the drafting, so far as the character in the hands of the person receiving is concerned. There is an incomplete correlation with s. 44, which gives an income quality to a distribution paid to a shareholder where it is paid “out of profits”. Neither s. 108 nor s. 109 supplies a deeming that the receiver is a shareholder, though that element might be thought to be carried by the deeming of the distribution or amount paid or credited to be a dividend, which is defined in s. 6 as an amount distributed
paid or credited to a shareholder. Neither provision deems the distribution or amount paid or credited to be “out of profits”. This aspect was considered in *Rutherford* (1976) 76 A.T.C. 4304. It is hard to see in what sense a payment can be said to be out of profits, when it is an outgoing in the gaining of profits.

Section 262: Commissioner's power to identify an interest element in a series of receipts

4.133 The possible use of s. 262 by the Commissioner to separate out and tax an element of interest in a series of payments is considered in [2.284] and [2.289] above.

Rewards for Services: Proposition 13

Sections 26(e); 26(ea); 26(eb); 26AAAA; 26AAAB: fringe benefits and other rewards for services

4.134 The possible operation of s. 26(e), s. 26(ea), s. 26AAAA and s. 26AAAB, in extending the ordinary usage principle whereby rewards for services are income has been considered in [2.367]–[2.374] and [4.38]–[4.83] above. Section 26(eb) may extend the ordinary usage principle by making an amount income if it is received under an understanding that the taxpayer will resume performing work for a person who is or was his employer, or a person to whom he renders or has rendered services. The more likely view is that s. 26(eb) merely confirms the ordinary usage principle. The amount received is income as a reward for services to be rendered.

Section 26AAC: acquisition of shares under a scheme for the acquisition of shares by employees

4.135 The effect of s. 26AAC in displacing the operation of s. 26(e) and, presumably, the ordinary usage principles whereby rewards for services are income, was considered in [2.25]–[2.26], [2.35] and [4.20]–[4.21] above. The effect of s. 26AAC in displacing the ordinary usage principle that the character of an item as income must be judged in the hands of the person who derives it, is considered in [4.85] above.

Section 26(h): fee or commission for procuring a loan of money

4.136 Section 26(h) provides that “the amount of any fee or commission received for procuring a loan of money” is income. The paragraph simply
confirms the operation of the ordinary usage principle that a reward for services has the character of income. The ordinary usage principle will operate even though the procuring of the loan is a casual act of service.

4.137 Section 26(h) does not in its terms extend to a fee for giving a guarantee. A fee for giving a guarantee, even though there is only an isolated transaction, will be within the ordinary usage principle. *Trenchard v. Bennett* (1933) 17 T.C. 420 is authority, though the decision in the case was that the receipt of shares was not a reward for the giving of the guarantee. The taxpayer had guaranteed payment of a dividend by a company and received shares in that company. Finlay J. concluded that the giving of the guarantee was the consideration furnished for the acquisition of the shares, which were a capital asset in the hands of the taxpayer. The reasoning and the conclusion would seem unacceptable. The fact that shares, when acquired, are a capital asset in the hands of the taxpayer, does not make them any the less a reward for services, and income.

Subdivision AA of Division 2 of Part III: payments made in consequence of termination of any employment; payments from superannuation funds; and annuity and pension receipts

4.138 Subdivision AA of Div. 2 of Pt III has four functions:

(i) to include in assessable income certain payments made in consequence of termination of any employment of a taxpayer;
(ii) to include in the assessable income of a member of a superannuation fund certain distributions from such a fund;
(iii) to include in assessable income certain annuity and pension receipts of a taxpayer, and of supplements to those receipts; and
(iv) to include in assessable income of a taxpayer certain receipts by way of commutation of an annuity or pension, or certain receipts by way of payment of the residual capital value of an annuity or pension.

The function of Subdiv. AA in relation to annuities and pensions has already been considered in [2.215]–[2.223] and [4.106]ff. above.

4.139 The function of Subdiv. AA in relation to payments made in consequence of the termination of any employment of a taxpayer and in relation to distributions from superannuation funds are of present concern. Attention is given to the operation of ss 27B and 27C in relation to those elements in the definition of an “eligible termination payment” in s. 27A(1) that are comprised in paras (a) and (b). Sections 27B and 27C and para. (a), it will be seen, include amounts in assessable income, in whole or in part, that would not be income under ordinary usage principles as to the derivation of a reward for services within an employment. These amounts
would be distinguished from rewards for services within an employment as being amounts for giving up rights under a contract of service, or for accepting a restriction on one's capacity to perform services. Sections 27B and 27C and para. (a), in another aspect of their operations, exclude from assessable income, as to some part, amounts that would be income by ordinary usage principles as rewards for services. They thus have including and excluding effects. In their excluding effect, they give tax relief to amounts that had, in a sense, accrued before 1 July 1983, and to other amounts that have accrued at any time and are made under an approved early retirement scheme (s. 27E) or are bona fide redundancy payments (s. 27F) or are invalidity payments (s. 27G).

4.140 The function of Subdiv. AA in relation to distributions from superannuation funds is to include in assessable income, in whole or in part, amounts that would not be income derived by a member of a fund under ordinary usage principles. Constable (1952) 86 C.L.R. 402, considered in [2.17] and [2.22] above, would have precluded their inclusion in assessable income.

4.141 Sections 27B and 27C have an exclusive operation in regard to items that are within the definition of “eligible termination payment”. This is the consequence, it has been noted ([4.5] above), of the words added to s. 25 (1) in 1984.

4.142 The justification in policy for the operation of s. 27B and s. 27C in relation to amounts within para. (a) of the definition of “eligible termination payment” that would not be income by ordinary usage, is that they should be seen as rewards for services or compensation for rewards for services. The justifications in policy for the operation of s. 27B and s. 27C in relation to amounts within para. (b) of the definition are several. In treating as assessable income that aspect of a distribution that reflects the contributions an employer has made to the fund, the provisions endorse a view that derivation of the employers' contributions should not be precluded by the fact that the contributions have moved through a superannuation fund. The employee should, at the time of distribution, be treated as having derived assessable income in the amount of those contributions. Justifications for treating as assessable income distributions which reflect the employee's own contributions that were the subject of a deduction allowable to him, and the accumulations of income in the fund, are not so easily stated. The justification in relation to so much of the amount distributed as reflects the employee's own contributions as were the subject of an allowable deduction would assert that the allowable deduction in effect involved a deferral of tax on the derivation of the amount which was the subject of the contribution. That deferral should not
be continued when the amount is distributed from the fund. The justification in relation to the accumulated income of the fund is similar. The income of the fund will have been specially treated: it will either have been exempt from tax in the hands of the fund or been given other privileged treatment. The exemption or privilege should be seen as a deferral of tax that should not continue when the amount is distributed. These deferrals of tax are given in the promotion of saving and a distribution is a likely occasion of consumption.

4.143 The operation of ss 27B and 27C and para. (b) of the definition of “eligible termination payment” is not confined to distributions from a superannuation fund to an employee. Contributions by a self-employed person that are allowable deductions may have been made to a fund by a self-employed person, and the self-employed person have been entitled to a deduction under ss 82AAS and 82AAT, and the fund may have enjoyed privileged treatment.

4.144 The justifications in terms of withdrawing a deferral of tax when the interest in promoting saving no longer operates, are reinforced by the provisions of s. 27D, which allow a “roll-over” of an amount that is within para. (a) or (b) of the definition and would otherwise be taxed under s. 27B and s. 27C. The roll-over may be made at the election of the taxpayer within a specified period following the making of the eligible termination payment. The roll-over requires a payment of the amount to a superannuation fund, to an approved deposit fund (defined in s. 27A(1)), or to a life assurance company or registered organisation in the purchase of an annuity. In all instances saving will continue. It will continue until a distribution is made to the taxpayer from the superannuation fund or the approved deposit fund, or a payment is made of the annuity. On distribution from the superannuation fund or approved deposit fund, assuming there is no election to roll-over further, there will be assessable income of the taxpayer under s. 27B or s. 27C. An annuity receipt will be income under s. 27H.

4.145 An approved deposit fund is an entity specially created to receive roll-overs. Its income will be exempt if the fund qualifies under s. 23FA. If it does not, its income is subject to tax under s. 121DAA.

4.146 Subdivision AA of Div. 2 of Pt III replaces s. 26(d), which achieved some of the functions of Subdiv. AA in a provision characterised by brevity, if not determinateness. It provided:

“The assessable income of a taxpayer shall include 5% of the capital amount of any allowance, gratuity or compensation where that amount is paid (whether voluntarily, by agreement or by compulsion of law) in a lump sum in consequence of retirement from, or the termination of, any office or employment, not being—
(i) an amount that, under any provision of this Act, is deemed to be a
dividend paid to the recipient; or
(ii) an amount to which section 26AC or 26AD applies.”

Some comparisons between the language of Subdiv. AA and s. 26(d) are made in
what follows.

Payments made in respect of a taxpayer in consequence of the termination of any
employment of the taxpayer

4.147 Paragraph (a) of the definition of “eligible termination payment”
provides that eligible termination payment means:

“(a) any payment made in respect of the taxpayer in consequence of the termination
of any employment of the taxpayer, other than a payment—

(i) to which paragraph (b) applies;
(ii) of an annuity, or supplement, to which section 27H applies;
(iii) from a fund in relation to which section 121DA applies, or has applied,
in relation to the year of income commencing on 1 July 1984 or any
subsequent year of income;
(iv) of an amount to which section 26AC or 26AD applies; or
(v) of an amount that, under any provision of this Act, is deemed to be a
dividend paid to the taxpayer.”

The excluded items are the subject of some comment in later paragraphs. The
significance of the words “in respect of the taxpayer” were the subject
of comment in [4.23] above. The immediate concern is with the notion of
“termination of any [office or] employment”.

4.148 “Termination of employment” has definitive significance in Subdiv.
AA. Where the question is whether an item of receipt for surrender of
rights to perform services is within ordinary usage principles, a notion of
termination of employment does not have such significance. In Henley v.
Murray [1950] 1 All E.R. 908, Evershed M.R. expressed the view that a
receipt while employment continues is likely to be regarded as a reward for
services, and explained Tilley v. Wales [1943] A.C. 386 and Cameron v.
Prendergast [1940] A.C. 549 on this basis. An employment may continue
for this purpose notwithstanding that there has been a change in contractual
relations under which services are performed, as for example in the facts of
Tilley v. Wales and Cameron v. Prendergast, or the Australian High Court
decision in Bennett (1947) 75 C.L.R. 480. Employment is thus a concept
that transcends contractual relations. In Henley v. Murray, Evershed M.R.
in referring to the United Kingdom cases, said (at 910): “the contract of
service remains in one form or another”.

4.149 “Employment” in the definition of an eligible termination payment may be a similar notion. An employment may not necessarily be terminated if the employee continues to serve, though he serves under a contract of service whose terms differ from the earlier contract. And a brief gap in time between the conclusion of service under one contract and the commencing of service under another may not involve a termination of employment. Reseek (1975) 133 C.L.R. 45 proceeded on the basis that there had been a termination of employment notwithstanding a continuance by the taxpayer of service under a new contract. But there was no argument directed to the matter.

4.150 If the notion of employment can be abstracted from the contract of employment, it may be possible to abstract it from the person of the employer. It would follow that an employee who serves a new employer who has acquired a business from his former employer may be held not to have experienced a termination of employment. An employee who ceases to work under a contract with a company and immediately enters a new contract might be held to continue in the same employment. In this instance, it may be relevant that there has been a significant change in the capacity in which he is employed.

4.151 The word “office” as it appeared in s. 26(d), and as it now appears in the definition of employment for purposes of Subdiv. AA of Div. 2 of Pt III, has not been the subject of any Australian judicial decisions. The meaning of the word, in a distinct context, has been considered in the United Kingdom in Great Western Railway Co. v. Bater [1920] 3 K.B. 266 and in Edwards v. Clinch [1982] A.C. 845. In the former case Rowlatt J. thought it was a sound argument that those who use the language “an office or employment” meant “an office or employment which was a subsisting, permanent, substantive position, which had an existence independent of the person who filled it, which went on and was filled in succession by successive holders, and that if a man was engaged to do any duties which might be assigned to him, whatever the terms on which he was engaged, his employment to do those duties did not create an office to which those duties were attached; he merely was employed to do certain things, and the so-called office or employment was merely the aggregate of the activities of the particular man for the time being” (at 274). A position established by statute or royal charter may fit the description. A position that has statutory recognition, though it is not established by statute, for example the office of director or auditor of a company, may also fit the description, though it would be doubted that one could create an office of consultant to a company by providing in the articles of association for the position. One
could not however create an office by the description of a position to be offered, or by the terms of a contract under which the position is filled.

4.152 The method of taxing an eligible termination payment under s. 27B and s. 27C, depends on the nature of the payment. Section 27C(1) is applicable to payments that relate in part to a period of service before 1 July 1983. Its general effect is to bring to tax only 5 per cent of the amount of an eligible termination payment that relates to service before that date. The operation of the section depends on the definitions of “eligible service period” and the calculation specified in s. 27C(1). Section 27C(2) has a like operation in regard to the “concessional component” of a termination payment, to whatever period of service it may relate. The assessable income of the taxpayer includes only 5 per cent of the amount. The concessional component is so much of a termination payment as relates to an approved early retirement scheme (s. 27E), a bona fide redundancy payment (s. 27F), or an invalidity payment (s. 27G).

4.153 Section 27B includes in assessable income the whole of an amount of a termination payment, where it relates to a period of service after 1 July 1983, save where it relates to an approved early retirement scheme, a bona fide redundancy payment or an invalidity payment. The amount included in assessable income is taxed in the same manner as other income of the taxpayer, subject however to a rebate provided for in s. 160AA that will impose generally a ceiling of 30 per cent. Where the taxpayer is over 55, the ceiling is 15 per cent in respect of the first $50,000.

4.154 A termination payment in respect of a taxpayer includes a payment made after his death to the trustee of his estate: s. 27A(3). Section 27A(4), however, provides that the payment in these circumstances shall be reduced by such amount as the Commissioner considers appropriate having regard to the extent to which the dependants of the deceased may reasonably be expected to benefit from the estate. “Dependant” is defined in s. 27A(1).

4.155 The items excluded from para. (a) of the definition of termination payment include an amount that is a termination payment by virtue of para. (b), which relates to distributions from a superannuation fund. Thus a payment from a superannuation fund in consequence of the termination of an employment is dealt with as a payment from a superannuation fund. As a payment within para. (b) its character as a payment in consequence of termination is not relevant.

4.156 The exclusion of the amount of an annuity or supplement to an annuity to which s. 27H applies, leaves s. 27H to operate outside of the code constituted by the provisions of Subdiv. AA applicable to eligible termination payments, with consequences noted in [4.158].
4.157 The exclusion of a fund to which s. 121DA applies leaves a distribution from such a fund to the operation of ordinary usage principles. A s. 121DA fund is not a superannuation fund as defined for purposes of Subdiv. AA. A distribution from a s. 121DA fund is not therefore within para. (b) of the definition of eligible termination payment. The distribution will in most instances not be income of the taxpayer who receives it: Constable (1952) 86 C.L.R. 402 will apply ([2.17] and [2.22] above). The income of s. 121DA fund does not attract exemption or privileged treatment. It is taxed at 60 per cent. Contributions to a s. 121DA fund are not allowable deductions to an employer (s. 82AAC(2) and s. 82AAR) or to an employee (s. 82AAS, definition of “qualifying superannuation fund”). There is therefore no justification in policy for taxing the distributions from the fund, except that the contributions by the employer, on the authority of statements in Constable, were not treated as assessable income of the employee. The fact that the contributions by the employer have not been taxed to the employee on their entering the fund has not been treated as significant when the eligible termination payment provisions are applicable.

4.158 The exclusion of an amount to which s. 26AC (relating to a payment in respect of unused annual leave) or s. 26AD (relating to a payment in respect of unused long service leave) applies, may operate in a different way from the exclusion in relation to s. 27H. It will be seen that, on the authority of the interpretation of words in the former s. 26(d), neither s. 26AC nor s. 26AD has any application to a payment in more than one amount. Such a payment is therefore not excluded from the definition of eligible termination payment, and will be taxed under s. 27B and s. 27C. Its treatment under those provisions may be more generous than under s. 26AC or s. 26AD, if one of them had applied. The deductible amount under s. 27H remains an amount to which s. 27H applies. It is not brought back into the operation of the eligible termination payments provisions. In the result, it may be subject to tax as ordinary usage income. That is a consequence that could not have been intended. But the words added to s. 25(1) in 1984, in their manner of making the eligible termination payment provisions a code, have excluded the possibility that any other specific provisions can be a code.

4.159 The last item excluded from para. (a) of the definition of eligible termination payment is an amount that under the provisions of the Assessment Act is deemed to be a dividend paid to the taxpayer. The principal illustration is s. 109, to which reference is made in [4.131]–[4.132] above. Section 109 is defective in a way disclosed in Rutherford (1976) 76 A.T.C. 4304. It may operate to deem an amount paid by a
company to a taxpayer who is a shareholder or director of the company, as a termination payment, to be a dividend that is income of the taxpayer. In the result the amount is taken out of the operation of ss 27B and 27C and brought within the operation of s. 109, but it may not be income of the taxpayer under that section. If it is not, the question will remain whether, having been taken out of the code applicable to termination payments by attracting s. 109, the item is now exposed to tax as ordinary usage income which is a reward for services. It would follow from the view taken in this Volume as to the effect of the words added to s. 25(1) in 1984, that it is so exposed. Items that are income by ordinary usage cannot be excluded from assessable income, save by express provision in terms lifting the operation of s. 25(1).

4.160 The drafting of para. (a) of the definition of eligible termination payment differs in a number of respects from the drafting of the former s. 26(d). Section 26(d) referred to the “capital amount of any allowance, gratuity or compensation” where “that amount is paid . . . in a lump sum in consequence of retirement from, or the termination of, any office or employment”. The words “capital amount” in s. 26(d) do not appear in the definition in para. (a) of eligible termination payment. Their meaning in s. 26(d) was always obscure, save that they were held to cover an amount that was paid in commutation of an annuity, as in McIntosh (1979) 79 A.T.C. 4325. The words “paid . . . in a lump sum”, after a good deal of controversy, were ultimately held in the decision of the Federal Court in Knight (1983) 83 A.T.C. 4789 to refer to a payment in one sum as distinct from several. A payment in two amounts thus became a simple way of avoiding the operation of s. 26(d). It is not open as a way of avoiding s. 27B and s. 27C. There is no reference to “lump sum” in the provisions which control the operation of those sections. Each of several payments attracts their operation. The words “allowance, gratuity or compensation” may have had a restrictive effect on the operation of s. 26(d). None of them seems appropriate to a payment from a superannuation fund that is a return of the taxpayer's own contributions. But the words do not appear in the definition of eligible termination payment. The word “payment” substitutes for them.

4.161 The phrase “in consequence of” in the reference in para. (a) of the definition of “eligible termination payment” to a payment made “ . . . in consequence of the termination of any employment of the taxpayer”, is common to s. 26(d) and the paragraph of the definition. In McIntosh the phrase, as it was used in s. 26(d), was held to bring into the definition an amount received in commutation of a pension that was undoubtedly being paid in consequence of termination. And in Freeman (1983) 83 A.T.C.
the phrase was held not to include amounts paid to directors of a company nominally as retiring sums, the amounts being paid to the directors from funds received by the company some time after the company had ceased to carry on business, and the employments of the directors had terminated. In the Federal Court, Northrop and Fisher JJ. said ((1983) 83 A.T.C. 4456 at 4472):

“In the present case it cannot be said that the taxpayers had any entitlement, in the sense of enforceable entitlement, to be paid the lump sums. They were essentially voluntary and gratuitous payments by the old company. Thus in our view the question is, in circumstances such as the present, whether there was sufficient causal nexus between the payment and the retirement to make the retirement the occasion of the payment.”

Observations in other cases carry the matter very little further than a requirement of “a sufficient causal nexus”. A mere temporal connection is not enough. On the other hand it is not necessary that the payment have the termination as its dominant cause.

A payment made from a superannuation fund

4.162 Paragraph (b) of the definition of “eligible termination payment” covers:

“any payment made from a superannuation fund in respect of the taxpayer by reason that the taxpayer is or was a member of the fund, not being a payment that is:

(i) income of the taxpayer; or
(ii) a benefit to which sub-section 26AF(1) applies,

reduced by any amount that has been or will be included in the assessable income of the taxpayer under subsection 26AF(2) in respect of the transfer by the taxpayer of a right to receive the payment or any part of the payment.”

4.163 The words “in respect of the taxpayer” have already been the subject of comment in [4.23] above. The significance of the exclusion of a payment that is income of the taxpayer is obscure. It is no doubt the intention, following the example of para. (a) where the intention is express, to exclude an amount that is income under s. 27H, a section concerned with annuities (including superannuation pensions) and supplements to such annuities. In this role the exclusion cannot refer to income in any sense other than income for purposes of the Assessment Act, though it is obviously necessary to imply a qualification which might be expressed as “other than an amount that is income as an eligible termination payment”. Otherwise the use of the word will create a circularity. It may also have
been the intention to exclude an amount that would be income because the distribution from the superannuation fund is held not to be covered by the decision in *Constable* (1952) 86 C.L.R. 402. There may be circumstances where the receipt is not simply in satisfaction of the taxpayer's rights in the fund, but can be identified with the contributions made by the employer to the fund in a way that was held not to be possible in *Constable*.

4.164 Section 26AF makes income a benefit of any kind, out of, or attributable to, assets of “a para. 23(ja) fund” (defined in s. 26AF(3)), “or a s. 23FB fund”, where the benefit is received or obtained otherwise than in accordance with approved terms and conditions applicable to the fund at the time when the benefit is received or obtained. There are other considerations which must be satisfied before the benefit is to be treated as assessable income, the conditions involving a discretion given to the Commissioner. There is also a provision in s. 26AF(2) which will make assessable income a receipt of valuable consideration in respect of the transfer by the taxpayer to another person of a right to receive a benefit from one of the funds referred to. The intention is to deny the privileged treatment given to “an eligible termination payment”, to a distribution in breach of fund conditions or to the proceeds of realisation of rights in a fund. Where a s. 26AF(2) amount has been or will be included in assessable income of the member of the fund, the amount will not be included again, as an eligible termination payment, in the assessable income of that taxpayer, on a payment being made from the superannuation fund to the transferee from that taxpayer. This is the effect of the reduction provided for in para. (b) of the definition of “eligible termination payment”. The prospect that there would be an eligible termination payment of the member on payment to the transferee arises from s. 27A(3) (a)(iii), referred to [4.23] above. Subsequent to the inclusion of the eligible termination payment provisions, s. 26AFA was added to the Act. It is a provision which in its reference—in s. 26AFA (1)—to s. 26(d), then already repealed, shows its origin as a matter of drafting in an earlier time. Section 26AFA makes provision in regard to s. 23F funds similar to those made in regard to s. 23(ja) and s. 23FB funds by s. 26AF. No express provision was inserted in the definition of “eligible termination payment” to deal with the addition of s. 26AFA. The non-application of the eligible termination payment provisions would appear to depend on the reference to s. 26(d)—“notwithstanding paragraph 26(d)”—or, perhaps, the exclusion from “eligible termination payment”, by para. (b)(i) of the definition, of a payment that is “income” of the member of the fund. The difficulty with the latter explanation involves the meaning to be given to the word “income” in para. (b)(i)—whether it extends beyond
ordinary usage income—and the need for the express reference to s. 26AF (1). The difficulty with the explanation in terms of the reference to s. 26(d) will be in treating the reference to s. 26(d) as a reference to the eligible termination payment provisions, as provisions replacing s. 26(d).

4.165 An understanding of the policy that is expressed in para. (b) of the definition of eligible termination payment and the provisions of ss 27B and 27C may be assisted by a review of the law in three areas: the tax treatment of receipts by superannuation funds; the tax treatment of income of superannuation funds; and, ss 27B and 27C aside, the tax treatment of distributions from a superannuation fund. Jurisdictional issues in relation to the taxing of superannuation funds were considered in [1.10]–[1.23] above.

4.166 A superannuation fund involves a trust and the office of trustee. If one excludes the operation of Div. 9B, in particular s. 121DB, Div. 6 of Pt III would be applicable, and the derivation of income by the trust would be determined on the hypothesis that the trustee is a taxpayer (s. 95). The significance of this hypothesis was the subject of observations in [4.26]–[4.30] and [4.96] above: it displaces the principle that beneficial entitlement is an essential quality of an income receipt. None the less, a conclusion that contributions to the trust, whether by the employer or by the employee, are income of the trust would not easily be drawn. The contributions, if made in a series, might be periodical receipts of the trust, though it would not be easy to find in the receipts any element that would bring them within the substance of the periodical receipts principle. That substance is examined in [2.175]–[2.208] above. At least in the case of employee contributions to the fund, the operation of a periodical receipts principle to give an income character to the receipts by the trustee would seem in any case to be precluded by the contribution to capital principle examined in [2.113]–[2.131] above. The hypothesis that the trustee is a taxpayer will give an income character to most other receipts by the trust, generally receipts from investments, that would have an income character if derived by an individual.

4.167 In relation to contributions by the employer, there is a further question: whether derivation by the trust is a derivation by the member employee in respect of whom the contributions were made. An argument may be made that there is an immediate benefit to the employee in the increase in the value of his interest in the fund, and that benefit is his income, either by the operation of ordinary usage, or by the operation of s. 26(e). The amount of income might be small if ordinary usage alone is to be considered, but it would be significant if s. 26(e) operates, when the amount of income would be the value to the taxpayer of the increase in his interest. In Constable (1952) 86 C.L.R. 402 the majority expressed the
view that there was no derivation of a benefit by the employee that would be his income as a reward for services, on the making of a contribution to the fund by the employer. The minority (Webb J.) took the contrary view. The majority view appears to have been accepted in the practice of the Commissioner, though the facts in Constable were special in that the contribution to the fund made by the employer was made in respect of all employee members, and it was the function of the trustee to make allocations to the accounts of individual members. Where a trustee receives a contribution made in respect of a particular employee, the argument that there is a derivation of a benefit by the employee that is a reward for his services is the stronger.

4.168 On distribution from the fund to a member of amounts representing the contributions of the employer, there would not be income receipts by the member. Constable is authority that where the occasion of receipt by the member is one of a “contingent right that became absolute” (at 418), the receipt does not have the character of a reward for services which it may have had in its origin as a payment by the employer. Constable has its parallel in the United Kingdom decision in Abbott v. Philbin [1961] A.C. 352 at 379, where the receipt of shares following the exercise of options granted by an employer was seen as proceeds of the “exploitation of a valuable right”.

4.169 A distribution from the fund to a member of amounts representing the contributions made by the member himself is simply a return of capital contributed by the member. On the authority of H. R. Sinclair Pty Ltd (1966) 114 C.L.R. 537, considered in [2.547]–[2.552] above, it would not be income of the member, even though the contribution by the member was deductible by him.

4.170 The returns from the trust's investments would be income of the trust, if they are within the income derived from property principle, and would be subject to tax as trust income under Div. 6. The tax on that income would generally be on the trustee, if it be assumed that there is no present entitlement in a member of the fund in the year of derivation by the trust, arising from an appropriation of trust income to the account of the member. There would, however, be the prospect of tax to a member on distribution to him under s. 99B—a provision that will apply to give rise to a tax liability on the member in respect of income not already taxed to the trustee.

4.171 Where the distribution from the fund would be said to have been received by the taxpayer in a lump sum in consequence of termination of employment, s. 26(d) would have been applicable if the payment had been made prior to 1 July 1983. Section 26(d) would have displaced any
operation of the ordinary usage concept of income. Reseck (1975) 133 C.L.R. 45 and Constable (1952) 86 C.L.R. 402 would have been irrelevant. Section 26(d) would presumably have displaced any operation of s. 99B.

4.172 The preceding paragraphs have sought to show the application of ordinary usage principles within the overlap of Div. 6 of Pt III. The conclusions reached are relevant to a fund that does not qualify as a superannuation fund within the definition in s. 121B of Div. 9B of Pt III. “Superannuation fund” is there defined to mean “a provident, benefit, superannuation or retirement fund”.

4.173 Where the fund is one within that definition, the overlap of Div. 9B must also be considered. The view was taken in [1.16]–[1.23] above that Div. 9B should be seen as adding to and modifying the structure of s. 25(1) and Div. 6 on which it builds, and not as a wholly distinct set of provisions.

4.174 The implications of the further overlap of Div. 9B may be summarily stated. Contributions to the superannuation fund whether by the employer or by the employee will not be income of the fund. This is the effect of s. 121B in the definition of investment income, s. 121D, s. 121DA and s. 121DAB. Division 9B, in this respect, simply confirms the operation of Div. 6. The income of a Div. 9B superannuation fund may be exempt from tax under one of the provisions—s. 23F, s. 23(jaa), s. 23(ja) and s. 23FB—which give exemption to certain of the income of superannuation funds. Where income is not thus exempt it may be taxed at a concessional rate or may be taxed at the maximum marginal rate applicable to an individual: s. 121CA, s. 121CB, s. 121D, s. 121DA and s. 121DAB.

4.175 The question whether a derivation by a superannuation fund of an employer's contribution is a derivation of a resulting benefit that is income of the employee will be answered, as it is answered in [4.167] above, in relation to a trust not subject to Div. 9B.

4.176 Distributions by the superannuation fund that do not qualify as eligible termination payments under para. (a) or (b) of the definition of “an eligible termination payment” in s. 27A(1), will not be income of the member of the fund if they are protected by the principles in Constable (1952) 86 C.L.R. 402. Presumably, s. 99B of Div. 6 would not operate. The inference from the terms of that section is that it applies only to a distribution from a fund whose income is subject to tax under Div. 6, a fund that is not a Div. 9B fund. Section 99B applies only to distributions from income that could have been taxed under ss 99, 99A, 97 or 98. The operation of those provisions in taxing the income of a Div. 9B superannuation fund is excluded by s. 121DB.

4.177 A distribution from a Div. 9B superannuation fund that is a s. 121DA fund will not be within para. (a) or (b) of the definition of eligible
termination payment. It is not a distribution from a superannuation fund as defined for purposes of Subdiv. AA, so that it cannot be within para. (b). And it is expressly excluded from para. (a). It follows that the distribution received by a member of such a fund will not be his income, so long as it enjoys the protection of the principles in *Constable*.

4.178 The treatment of a distribution from a superannuation fund that is within para. (a) or (b) of the definition of eligible termination payment may now be considered. A distribution may be within para. (a) if it is a distribution from a fund that is not a superannuation fund within Div. 9B, and is thus a fund taxed under Div. 6. The situation may be remote in view of the wide definition of superannuation fund for purposes of Div. 9B, but it cannot be dismissed. A distribution from a superannuation fund that is a Div. 9B fund cannot be within para. (a). This is the consequence of the exclusion from para. (a) of distributions within para. (b), and the express exclusion of a distribution from a s. 121DA fund. It was necessary to exclude expressly a distribution from a s. 121DA fund because the definition of a superannuation fund for purposes of para. (b), while including other Div. 9B funds, does not include a s. 121DA fund. A distribution to which para. (a) applies will be taxed under ss. 27B and 27c in ways already explained.

4.179 A distribution from a superannuation fund that is within para. (b) will be taxed under the provisions of s. 27B and s. 27c in ways already explained. Where s. 27B in other respects includes the whole of an amount in assessable income, a deduction from the amount so included is allowed, being the amount of undeducted contributions. “Undeducted contributions” are defined in s. 27A (1) so that they mean “so much of the eligible termination payment as is attributable to contributions made by the taxpayer, or any other person, after 30 June 1983 to a superannuation fund in order to obtain superannuation benefits, being contributions in respect of which no deduction is allowable or has been allowed to the taxpayer or the other person”. The intention is primarily to exclude from tax at the time of distribution from a fund an amount that might be said to have been taxed at the time of contribution to the fund. It will have been taxed if it has not been the subject of an allowable deduction to the employee or employer, and the employee or employer had income against which a deduction might have been allowed. The inclusion in “undeducted contributions” of an amount contributed by an employer that was not the subject of an allowable deduction by the employer may, in any event, have unintended consequences. The taxpayer's employer may be an exempt body which cannot have allowable deductions. The amount of the employer's contributions in these circumstances cannot in any sense be said to have
been taxed at the time of contribution to the fund. It may be possible for a court, relying on *Cooper Brookes (Wollongong) Pty Ltd* (1981) 147 C.L.R. 297, to give the definition of undeducted contributions a construction which will preserve the policy it was intended to express.

**4.180** The taxation of distributions from superannuation funds reflects policies to which reference has already been made. These policies are:

(i) Where a contribution to a superannuation fund may be said to have been made from income that has not been taxed because a deduction has been allowed to the taxpayer or to his employer in respect of the contribution, it ought to be subject to tax when it is distributed from the fund;

(ii) Where the income derived by a superannuation fund from the investment of contributions has enjoyed significant relief from tax in the hands of the fund, it ought to be subject to tax when it is distributed from the fund. One observation might be made in regard to those policies. The fact that an employer has been denied a deduction of a contribution to a superannuation fund so that he has been taxed on income whence the contribution was made, ought not to be sufficient to justify relief from tax to the employee on the distribution to the employee of the amount of that contribution. The policy should not extend beyond relief from tax on distributions to the employee where the amount of the distribution was taxed to the employee at the time of the contribution of that amount to the fund. Subdivision AA has accepted the statement of the majority in *Constable* (1952) 86 C.L.R. 402 that the employer's contributions to a superannuation fund are not income of the employee at the time of their contribution, but has not fully corrected the distortion that flows from that conclusion.

**Exceptions applicable to paras (a) and (b) of the definition of “eligible termination payment”**

**4.181** The definition of eligible termination payment in s. 27A(1) is subject to three exceptions. The first of these (para. (k) of the definition) is a payment by way of advance or loan made on terms and conditions similar to the terms and conditions that could reasonably be expected to apply in respect of an advance or loan to the payee, by a person with whom the payee was dealing at arm's length in relation to the advance or loan. The exception at once confirms that a loan may be a payment for purposes of para. (a) or (b) of the definition and provides for an exception of what may be seen as a genuine loan. It is an anti-avoidance provision. The genuine loan will not be income of the taxpayer who receives it.
4.182 The second exception (para. (m)) is “consideration of a capital nature for, or in respect of, a legally enforceable contract in restraint or trade by the taxpayer, to the extent to which the amount or value of the consideration is, in the opinion of the Commissioner, reasonable having regard to the nature and extent of the restraint”.

4.183 The second exception is only significant where the amount of the consideration would otherwise be an eligible termination payment within para. (a) of the definition. And the exception only operates in relation to “consideration of a capital nature” which, presumably, means an amount that would not be income under ordinary usage principles. Consideration received under a provision of a service agreement, or an amended service agreement, which is payable immediately on the making of the agreement could not be said to be a payment in consequence of termination so as to be within para. (a) of the definition. Where the consideration is to be paid on termination, though provided for in the service agreement, it may be held to be within the definition. Where the consideration is payable under the terms of an agreement by which the employment is terminated it will be within the terms of the definition. A payment under the terms of a distinct agreement entered into after termination may be within the terms of the definition: the issue will be whether there is a sufficient causal nexus between the termination and the payment. The question whether the consideration is within the exception as consideration of a capital nature will be answered in terms of the authorities discussed in [2.409]ff. above. In some circumstances a receipt which is, as a matter of form, a receipt for a restrictive covenant, may be held to be a further reward for services and income on that ground. The exception will not operate and the amount will remain an eligible termination payment to be taxed under Subdiv. AA, if it can be said to be a payment in consequence of termination.

4.184 The exception is confined to an amount which is in respect of a “legally enforceable contract”. Under ordinary usage principles an amount may be held not to be income because it is an amount for accepting a restriction on one's freedom of action, notwithstanding that the restriction is not legally enforceable against the taxpayer. The matter is considered in [2.414] above. That amount will not, however, attract the exception, and will be taxed as an eligible termination payment if it is received in consequence of termination. The law in regard to the enforceability of restrictive covenants is likely to undergo some development in the future in tax cases.

4.185 The third exception takes out of the definition:

“(n) consideration of a capital nature for, or in respect of, personal injury to the
taxpayer, to the extent to which the amount or value of the consideration is, in the
opinion of the Commissioner, reasonable having regard to the nature of the personal
injury and its likely effect on the capacity of the taxpayer to derive income from
personal exertion;”

There will be circumstances in which consideration received in respect of personal
injury will be received in consequence of termination of employment. An agreement
in which a taxpayer relinquishes his employment may contain a provision by which
he is compensated for personal injury suffered in the course of his employment. If the
consideration is in substance for the personal injury, it will come within the exception
if it is of a capital nature. Generally it will be of a capital nature. The discussion in
[2.542] above would indicate that a receipt by way of damages for personal injury
will not be income despite an element of economic loss to which the damages award
202 at 209 support such a view. A receipt under an agreement of the kind suggested
may be treated differently, more especially if an amount is specifically appropriated
to an element of economic loss. There will, of course, in relation to a payment referable
to several elements, be problems arising from the application of McLaurin (1961) 104
C.L.R. 381 and Allsop (1965) 113 C.L.R. 341. In that regard a question may arise
whether an amount becomes an amount “of a capital nature”—the words of para.
(m)—because the whole receipt includes an amount in respect of an element of a
capital nature from which an amount in respect of an element of an income nature
cannot be separated.

4.186 The more likely circumstances in which exception (n) will be
relevant is a payment from a superannuation fund that would otherwise be
an eligible termination payment within para. (b) of the definition of eligible
termination payment. A superannuation fund, as defined for purposes of
Subdiv. AA of Div. 2 of Pt III, may include a fund that provides retirement
benefits and provident benefits which will include payments in respect of
personal injury suffered by a member of the fund. The views of Barwick
C.J. will be relevant on the question whether the receipt is of a capital
nature. If it is of an income nature it will in any event be outside the
definition of eligible termination payment. This is the effect of para. (b)(i)
of the definition. In Slaven (1984) 84 A.T.C. 4077 the provisions of the
Victorian Motor Car Act were held to determine the character of receipts
for personal injury and to give them a non-income character. In that case
the payments under the Victorian Motor Car Act were expressed by the
Act to be for loss of earning capacity. The provisions of the trust deed of
the superannuation fund may determine the character of the payment by the
fund, though the significance to be given to the words of a trust deed may
not be the same as the significance to be given to the words of a statute.

Sections 26AC; 26AD; sums in lieu of annual leave and long service leave

4.187 Section 26AC, inserted in 1978, applies to lump sum payments made
after 15 August 1978, in consequence of a taxpayer's retirement from, or the termination of an office or employment, where the lump sum is in lieu of annual leave. The whole of the amount is income: the section confirms a characterisation that would follow from the ordinary usage meaning and the exclusion of the operation of Subdiv. AA of Div. 2 of Pt III by the definition of “eligible termination payment”. Section 160AA allows a rebate of tax, so as to limit the rate of tax applicable to the standard rate.

4.188 Section 26AD, inserted in 1978, applies to lump sum payments made after 15 August 1978 in consequence of a taxpayer's retirement from, or the termination of an office or employment, where the lump sum is in lieu of long service leave entitlement attributable to qualifying service after 15 August 1978. The whole of the amount is income: the section confirms a characterisation that would follow from the ordinary usage meaning and the exclusion of the operation of Subdiv. AA of Div. 2 of Pt III by the definition of “eligible termination payment”. Section 160AA allows a rebate of tax, so as to limit the rate of tax applicable to the standard rate. Section 26AD raises problems of interpretation similar to those raised by s. 26(d).

4.189 Sections 26AC and 26AD continue to use the words “paid . . . in a lump sum” that first appeared in s. 26(d), now repealed and replaced by Subdiv. AA of Div. 2 of Pt III. Subdivision AA, it has been noted, does not use those words. As interpreted in Knight (1983) 83 A.T.C. 4789, those words are not satisfied if the relevant amount is paid in more than one instalment. There is in the result a way of avoiding the operation of s. 26AC or s. 26AD. If an amount is paid in more than one instalment it will not be an amount to which either section applies. It will thus, as a “payment in consequence of the termination of any employment of the taxpayer”, fall within para. (a) of the definition of “eligible termination payment” and be subject to tax under ss 27B and 27C with consequences explained in [4.138]ff. above.

**Business Gains: Proposition 14**

**Section 26(g): bounties and subsidies**

4.190 The effect of s. 26(g), in expressly providing that “any bounty or subsidy received in or in relation to the carrying on of a business (other than subsidy received under an agreement entered into under an Act relating to the search for petroleum)” is income, was the subject of some comment in [2.131] above. Its general effect is, it seems, to confirm that bounties or subsidies which are within the ordinary usage meaning, are
income. The words in parentheses, however, raise a problem of the kind raised by the now repealed s. 26(d) and the subject of the decision in Reseck (1975) 133 C.L.R. 45. The intention, presumably, was to take the items mentioned out of the meaning of income for purposes of the Act. But the inference to be drawn from the words added to s. 25(1) in 1984 defeats that intention. The general issue is considered in [1.39], [2.223], [2.369] and [4.5] above.

Sections 28–34, 51(2): the trading stock regime

4.191 Sections 28–34, in combination with s. 51(2), displace the ordinary usage principle that to be income an item must be a gain by the taxpayer, and the principle that an item is income only if it has been derived by the taxpayer. It displaces these principles in the context of continuing business dealings with “trading stock”, as defined in s. 6.

4.192 Were it not for these provisions, the operation of the ordinary usage notion of income would require that:

(i) only the profit element on the realisation of a non-wasting revenue asset is income;
(ii) the costs of the asset are not deductible, though they are subtractable in computing the profit; and
(iii) there is no income item until the asset has been realised.

4.193 By inference, ss 28–34 and s. 51(2) make the whole proceeds of realisation of an item of trading stock income, when the realisation is in the course of carrying on a continuing business. Section 51(2) provides that “expenditure incurred or deemed to have been incurred in the purchase of stock used by the taxpayer as trading stock shall be deemed not to be an outgoing of capital or of a capital nature”. Some observations on this provision made by Dixon C.J. in John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 may suggest that it is intended to overcome doubts about deductibility thought to be unreal. With respect, the function is to displace a principle which would otherwise require that the outgoing be “capitalised”, in one accounting sense of the word, and treated as a cost which will be subtracted in computing the profit which is income on realisation of the item of stock. It is in this sense that the cost would otherwise be regarded as “of a capital nature”. The sense is different from that in which the words are understood in the contradistinction between working expenses, and expenses which are of a capital nature because they relate to the structure of the business. It is a corollary of the allowance of a deduction for the cost of trading stock that the whole proceeds of
realisation will be income. The same result would follow in any event from the operation of s. 82, which will deny the subtraction of a cost in computing a profit which is income, where that cost has been allowed as a deduction. These matters are the subject of further consideration in Chapter 14 below.

4.194 The requirement of the ordinary usage notion of income that an element of profit is not income until the revenue asset has been realised is displaced by ss 31 and 32 of the Assessment Act, to the extent that the taxpayer may in effect elect that an unrealised profit on an item of trading stock will be treated as present income derived. This election is made by selecting market value as the value of stock to be taken into account at the end of the year of income where market value exceeds cost. The cost of trading stock is deductible in the year of acquisition. But the effect of ss 28–29 is that this deduction is offset, where the item is not realised in the year of income in which it is acquired, by the operation of the provision that the excess of the value of closing stock over opening stock is income. The deduction is thus deferred until the item is realised. Where the taxpayer elects that the item should be brought to account at market value at the end of the year of income, the result will be the bringing in of an amount of unrealised profit.

4.195 In relation to livestock this election is controlled by s. 33. And it will be apparent that where there is an unrealised loss, the operation of an election is to allow a deduction of the unrealised loss.

Sections 36–37: gain on the disposal of trading stock otherwise than in carrying on the business, or on death

4.196 Where trading stock which are or were assets of a continuing business are disposed of otherwise than in the ordinary course of carrying on the business, s. 36 requires that the value of the trading stock shall be included in the taxpayer's income. The effect is to displace the ordinary usage principle that a business gain is income only when it arises from an act done in carrying on a business.

4.197 Section 37 provides that where trading stock of a business devolve by reason of death the value of the stock is income. The effect is also a displacing of the ordinary usage principle.

4.198 The operations of ss 36 and 37 extend not only to trading stock, but also to standing or growing crops, crop-stools, or trees which have been planted and tended for the purpose of sale. The operations of ss 36 and 37, in these contexts, assume that the costs associated with the standing or growing crops, crop-stools, or trees which have been planted and tended
for the purpose of sale are deductible as incurred. In this there is some contradiction of the ordinary usage principle that would require that such costs should be “capitalised” and subtracted in determining the profit on realisation.

4.199 The operation of s. 36 is qualified by s. 36A, and the operation of s. 37 by s. 37(2). Sections 36, 36A and 37 are further considered in Chapter 14 below.

4.200 Sections 36AAA and 36AA operate in various ways to displace the business gains principle, so as to defer the derivation of income, where gains which would otherwise be regarded as derived arise on the forced disposal, death or compulsory destruction of livestock.

Sections 38–43: income of a non-resident that has an Australian source

4.201 Sections 38–43 are concerned with the determination of the amount of profits from the realisation of trading stock which will be income and have an Australian source. The sections have a history which includes an earlier time when Australia did not assert jurisdiction to tax on the basis of residence of the taxpayer, and they are imperfectly adapted to the present assertions of jurisdiction. When read with other provisions of the Act, their operation is confined to the determination of Australian source income of a non-resident, and, possibly, to the determination of foreign source income of an Australian resident which may be exempt under s. 23(q).

4.202 The effect of s. 43 is to displace the operation of the trading stock provisions, ss 28–31 and 51(2), considered above, and, probably, ss 36–37. Section 43 confirms ordinary usage principles, though it may be arbitrary in the specifying of the costs that may be subtracted in computing the profit that is income.

Sections 129, 143: amounts deemed to be taxable income

4.203 In some of its provisions—ss 129 (overseas ships), 143 (non-resident insurer)—the Assessment Act deems an amount to be “taxable income”. In no case is any extension of the ordinary usage meaning of income intended. The operation of the sections is generally to impute allowable deductions determined by reference to the amount of income which is assessable. Difficulties of ascertaining the amount of allowable deductions are thus overcome in a manner that is to a degree arbitrary.

Compensation Receipts: Proposition 15

Section 26(j): receipts by way of insurance or indemnity
4.204 Section 26(j) was the subject of some observations in [2.553]-[2.557] above. In [2.553] above, attention was drawn to the possibility that s. 26(j) is a code in regard to receipts by way of compensation, and displaces at least in part the ordinary usage principles in regard to compensation receipts. The extent of the displacement would depend on a conclusion as to the extent of the field that s. 26(j) must be taken to have covered. A submission that s. 26(j) is a code in relation to receipts by way of insurance or indemnity was made in the Board of Review proceedings in Carapark Holdings Ltd (1967) 115 C.L.R. 653, but was not made in the appeal to the High Court. It has been assumed in this Volume that s. 26(j) does not displace the operation of the ordinary usage notion of income. Any conclusion that it is a code would contradict the inference to be drawn from the words added to s. 25(1) in 1984. The general issue is considered in [1.39], [2.223], [2.369] and [4.5] above.

4.205 In one respect, at least, s. 26(j) extends the meaning of income in the Act beyond its meaning in ordinary usage. The section makes income an amount received by way of insurance or indemnity for or in respect of “any loss or outgoing which is an allowable deduction”. It will be recalled that the ordinary usage compensation receipt principle, as it is formulated in Carapark Holdings, may make income a compensation receipt in respect of an outgoing “on revenue account”. An item may be an allowable deduction, though it is not an outgoing on revenue account. A receipt under an insurance policy which provides for the payment to the taxpayer, in the event of his illness, of the amount of contributions the taxpayer has undertaken to make to a self-employed superannuation fund, would be income under s. 26(j), but not under the ordinary usage compensation receipts principle. The contributions, it is assumed, are deductible under s. 82AAT, but they are not outgoings on revenue account.

4.206 A number of questions depend for their answers on the meaning of the words “in respect of” in s. 26(j). Herron and Sugerman JJ. in Williamson v. Commissioner for Railways [1960] S.R. (N.S.W.) 252 considered that s. 26(j) made income a compensation payment for a gate and fencing destroyed by fire, because expenditure on those items by a primary producer were at the time made allowable deductions by specific provisions of the Act. If the words “in respect of” are given the widest meaning they can carry, it is possible to say that the compensation is in respect of the expenditure incurred in erecting the gate and fence destroyed, or in the erecting of a new gate and fence.

4.207 A wide meaning for the words “in respect of” in s. 26(j) could involve a substantial extension of the meaning of income, so that an amount which is calculated by reference to income gains that would have
been derived from, or from the use of a capital asset, will be income, though it would not have been income under the ordinary usage principle. The operation of the ordinary usage principle is considered in [2.506]-[2.552] above. In *Williamson*, Sugerman J. expressed the view that s. 26(j) does not extend the meaning of income in this way. There is support for this view in *Polites v. Hydro-Electric Commission* (1978) 78 A.T.C. 4013, and it was adopted in *Slaven* (1984) 84 A.T.C. 4077.

4.208 It would appear from *Allsop* (1965) 113 C.L.R. 341 and *H. R. Sinclair Pty Ltd* (1966) 114 C.L.R. 537 that s. 26(j) does not extend the ordinary usage meaning of income so that an amount by way of refund, in a sense which will describe the receipts in those cases, will be income as a compensation receipt. The limitation on the ordinary usage principle of compensation receipts which arises from those cases is considered in [2.547]ff. above.

4.209 Section 26(j) is clearly not limited in its operation by any requirement that the receipt of compensation must be a business gain. Attention was drawn in [2.507] above to an assumption that appears to have been made in *Carapark* that the ordinary usage compensation receipts principle is simply a special application of the business gains principle, and that it has no independent operation. Other authorities contradict that assumption. If, however, it is a correct assumption, s. 26(j) will assume special importance as an extension of the ordinary usage meaning of income.

4.210 Because s. 26(j) has some operation in extending the ordinary usage meaning, it becomes important to know what the scope of the paragraph may be in other respects. There is some assistance in judicial interpretation, though a number of questions remain unresolved. Opportunities to consider the scope of the paragraph were not taken in *Allsop, Sinclair* and *Carapark Holdings Ltd* (1967) 115 C.L.R. 653.

4.211 The word “is” in the phrase “which is an allowable deduction” may suggest that s. 26(j) has no application to a receipt of compensation in respect of an item of loss or outgoing which has not been incurred at the time of the receipt. A like suggestion might be drawn from the phrase “which would have been income” in s. 26(j), where the item is a loss of profit or income. Sugerman J. in *Williamson v. Commissioner for Railways* considered that s. 26(j) could apply in relation to a prospective item. Walsh J. expressed doubt. The majority judges, Hogarth and King JJ. in *Lonie v. Perugini* (1977) 77 A.T.C. 4318 considered that s. 26(j) had no application to compensation for a future loss of profits. The dissenting judge, Bray C.J., thought that s. 26(j) could apply to future losses. Hutley J.A. in *Pennant Hills Restaurants Pty Ltd v. Barrell Insurances Pty Ltd* (1978) 78
A.T.C. 4032 expressed agreement with Bray C.J.

4.212 The meaning of the words “by way of insurance or indemnity” remains unresolved. Dixon and Fullagar JJ. in *Wade* (1951) 84 C.L.R. 105 at 112 observed:

“No doubt s. 26(j) is primarily directed to the recovery under a policy of insurance or other contract of indemnity of the amount of any loss. But the word ‘indemnity’ is not qualified and it expresses a notion which, it may be said, the ‘compensation’ awarded under the Milk Act . . . ought to satisfy.”

The reference to the Milk Act was a reference to an Act providing for compensation upon the compulsory destruction of diseased dairy cattle. In the same case Kitto J. held (at 115) that the words “by way of . . . indemnity” may be satisfied as well by a receipt pursuant to a statutory right as by a receipt under a contract. In *Williamson v. Commissioner for Railways* [1960] S.R. (N.S.W.) 252 at 274, Sugerman J. held that s. 26(j) “should . . . be construed as extending to receipts by way of compensation otherwise within its terms (including awards of damages) as well as to receipts by way of insurance”. In *Goldsbrough Mort & Co. Ltd* (1976) 76 A.T.C. 4343 Walters J. held that s. 26(j) applied to a receipt by the vendor, on the completion of a contract of sale of land, or part of an amount he had paid for rates.

4.213 In *Goldsbrough Mort* the item in respect of which compensation was received—the payment of rates—had occurred before the making of the contract of sale. It is arguable that “by way of insurance or indemnity”, however widely construed in other respects, should be held to extend only to circumstances where the right to compensation may be said to subsist before the loss or outgoing is incurred. An argument of this kind was made by the taxpayer in *National Commercial Banking Corp. of Australia Ltd* (1983) 83 A.T.C. 4715. It was accepted by Hunt J. at first instance who declined to follow *Goldsbrough Mort*. The Federal Court, on appeal, found it unnecessary to decide the question. The court said (at 4722): “Even if [s. 26(j)] were given its widest meaning of reimbursement to the taxpayer of an outgoing which was an allowable deduction (see in particular the judgment of Walters J. in the *Goldsbrough Mort* case) the joining fee would not answer that description for the reasons already given by us.” Those reasons are referred to and are the subject of some comment in [2.570] above.

4.214 No suggestion has been made in any case decided since 1973 that an inference should be drawn from the language of s. 26(k) that the words “insurance or indemnity” in s. 26(j) have a narrow meaning. In 1973, s. 26(k) was amended so that it refers to an amount received “by way of
insurance, indemnity, recoupment, recovery or reimbursement”.

4.215 The language of s. 26(j) is confusing, in that it uses the word “loss” in three distinct senses. In the phrase “loss . . . of trading stock” the sense of the word is “deprivation”—an event which gives rise to a loss in the second sense in which the word is used. This second sense is the one intended in the phrase “loss . . . of profit or income”. It is the failure to realise a gain. A third sense is intended in the phrase “loss or outgoing”, where the reference is to a failure of an asset to realise its cost.

Section 26(k): receipt in respect of a loss allowable under section 71

4.216 As now drafted, s. 26(k) uses the widest of language to make income a receipt “by way of insurance, indemnity, recoupment, recovery or reimbursement in respect of the whole or part of a loss that has been allowed or is allowable under s. 71 . . . ”.

4.217 Like s. 26(j), s. 26(k) extends the ordinary usage principle in regard to compensation receipts: it will apply to compensation in respect of a “loss” that may not involve a loss or outgoing on revenue account. Section 71 is intended to allow deductions in circumstances where, at least in the view of Kitto J. in Levy (1960) 106 C.L.R. 448, there would not be a deduction under s. 51.

4.218 The word “loss” as used in s. 26(k) and in s. 71 may be confusing. The reference is to a deprivation of money. It is not inappropriate to allow a deduction of the value of a deprivation where the item is cash. None the less, the deduction is strictly of a loss, in the sense of the failure of a revenue asset to realise its cost. Where the item is a revenue asset other than money, the deduction should be the amount of the cost of the asset, not its value at the time of deprivation.

4.219 Section 26(k) extends the ordinary usage meaning of income by applying to an amount “by way of reimbursement”. It will be recalled that the ordinary usage principle of compensation receipts does not extend to a “refund”, in a sense that will describe the receipts in Allsop (1965) 113 C.L.R. 341 and Sinclair (1966) 114 C.L.R. 537.

Section 63: recoupment of a loss that has been the subject of a write-off

4.220 Section 63(1) allows a deduction for the write-off of certain bad debts. The operation of the subsection is considered in [10.50]–[10.82] below. Its effect is to advance the allowance of a deduction, which would become allowable in any case when the debt is realised by disposition or discharge. At least this is so if it be assumed that debts owing to a person who is in business as a money lender are revenue assets.
4.221 Section 63(3) makes income an amount received in respect of a debt for which a deduction has been allowed. There may be some doubt whether the ordinary usage compensation receipts principle would extend to a recoupment of this kind. In any case the recoupment would appear to be income as a business gain.

4.222 Section 63(3) will presumably be applicable in circumstances beyond the allowance of a deduction under s. 63(1). Debts which are revenue assets may include debts not referred to in s. 63(1). A loan to an employee, or to a trader's customer or supplier, may be a revenue asset, and a loss suffered by the lender on the disposition or discharge of such a debt will be deductible as a working expense. A recoupment of such a loss would appear to be within s. 63(3).

Section 72: refund of an amount paid for rates or taxes

4.223 Section 72(2) provides:

“Where a taxpayer receives in the year of income a refund of an amount paid for rates or taxes which has been allowed or is allowable as a deduction, or in respect of which a rebate of tax has been allowed or is allowable, in an assessment for income tax under this Act or a previous law of the Commonwealth, his assessable income shall include that amount.”

4.224 A deduction for rates or taxes may be allowable under s. 72(1) where the amount is paid in respect of land used for the purpose of gaining or producing income, or under s. 51 where the rates or taxes are working expenses. Section 72(2) will make any refund income, where the refund is of an amount of rates or taxes deductible under s. 72(1) or s. 51(1). The rates or taxes referred to in s. 72(2) may, it seems, extend beyond those of which s. 72 allows a deduction: Sinclair (1966) 114 C.L.R. 537. In making a refund income, s. 72(2) extends the ordinary usage principle of compensation receipts. Indeed s. 72(2), and a provision in s. 74(2) in regard to refunds of election expenses, were relied on in Sinclair as express provisions demonstrating that there was no general principle of ordinary usage by which refunds as such can be income as compensation receipts. Observations on the decision in Sinclair have been made in [2.547]–[2.552] above.

4.225 Section 72(2) makes income a “refund of an amount paid for rates or taxes . . . in respect of which a rebate of tax has been allowed or is allowable”. In this aspect, s. 72(2) reflects a change made in the law in 1975 whereby a concessional deduction for rates or land tax in respect of a taxpayer's sole or principal residence, was replaced by a concessional rebate. There is a ceiling imposed by s. 72(1D) on the amount which may
be a “rebatable amount” under s. 159V. If the total of this and other rebatable amounts exceeds a specified amount, currently $2,000, the taxpayer is entitled to a rebate of tax of 30 per cent of the amount by which the total of his rebatable amounts exceeds $2,000: s. 159N. Section 72(2) will require that the taxpayer treat as income a refund of an amount “in respect of which a rebate of tax has been allowed or is allowable”. Presumably there can be no operation of s. 72(2) in this aspect unless the taxpayer's total of rebatable amounts exceeded $2,000. There will then be a question of how much of the rebatable amount in respect of rates and land tax is an amount in respect of which a rebate of tax has been allowed or is allowable. It is curious that the amount of a refund which can at best have generated relief from tax at 30 cents in the dollar, should be subject to tax at the taxpayer's marginal rate.

4.226 Section 72(2) in its application to refunds of rebatable amounts clearly extends the ordinary usage meaning of income.

Section 82AAQ: refunds of contributions to a superannuation fund

4.227 Subdivision AA of Div. 3 of Pt III is a code (s. 82AAR) in regard to the deduction of contributions made by an employer to a superannuation fund for the benefit of employees. Section 82AAQ provides that where an employer has been allowed a deduction and thereafter receives a payment or benefit from the fund, the amount of the payment or the value of the benefit is his income. Section 82AAQ extends the ordinary usage principle of compensation receipts so as to make a refund income. It has a function like that of s. 26(k) and s. 72(2). The refund would presumably be income in any event under the business gains principle.

Section 59(2)–(5): amounts received that recoup depreciation allowed

4.228 Subsections (2)–(5) of s. 59 will make income the amount or value received or receivable, under a policy of insurance or otherwise, in respect of the loss or destruction of an item of property in respect of which depreciation has been allowed or is allowable. The amount is income only to the extent that it recoups a deduction that has been allowed or was allowable under s. 54. It will be seen in [10.188]ff. below that it will recoup a deduction if it exceeds the depreciated value of the item of property, and only to the extent that it does not exceed the cost of the item on which depreciation has been allowed.

4.229 Subsections (2)–(5) of s. 59 stand outside the ordinary usage principle of compensation receipts, in that they relate to the recoupment of an outgoing which was not on revenue account.
There may be thought to be some overlap with s. 26(j). If there is, the more specific provisions will presumably prevail. There will however only be an overlap if s. 26(j) is held to extend to compensation for property in relation to which an outgoing has been allowed. It has been noted in [4.206] above that such an operation for s. 26(j) was contemplated by Sugerman J. in *Williamson v. Commissioner for Railways* [1960] S.R. (N.S.W.) 252.

**Sections 122K, 123C, 124AM, 124G, 124JB, 124P: amounts received that recoup the allowance of deductions in respect of capital expenditure**

Reference was made in [4.103]–[4.105] above to a number of sections which have the effect of reversing the allowance of deductions in respect of capital expenditure, when an amount received on the disposal of property recoups that expenditure. The sections are s. 122K (general mining), s. 123C (transport of minerals), s. 124G (timber operations), s. 124JB (timber mill buildings) and s. 124P (commercial or industrial property). Those sections are also applicable when an amount is received on the loss or destruction of the property, under a policy of insurance or otherwise, in respect of the loss or destruction.

The sections operate in a fashion similar to subss (2)–(5) of s. 59 and the comments made above in relation to subss (2)–(5) of s. 59 are relevant.

**The Interpretation of Specific Provisions**

Specific provisions, whereby an item may be made income or excluded from income, differ in an important respect from the ordinary usage notion of income operating through the use of the word “income” in s. 25. Any specific provision is likely to be framed in words that are, or become by interpretation, words of legal art. As such, they invite the adoption of legal forms which will engage or escape the operation of the specific provision, as the interests of the taxpayer may direct. An approach to the application of the Assessment Act which prefers form to substance will reinforce the action of the taxpayer. A form approach will insist that where the Act in its specific provisions invites the adoption of a legal form, the application of the Act must be determined by reference only to the form that has been adopted. Indeed, it might be said that there is no room for a substance approach, because there is no relevant substance. The identification of substance is the identification of a broad principle which will not be expressed in terms of legal art. There are no broad principles in the provisions which seek to extend or modify the ordinary usage meaning of income.
4.234 The more the words of a specific provision become words of legal art by interpretation, the more is the invitation to adopt legal forms which will engage or escape the operation of the provision. An illustration is afforded by the interpretation of the word “royalty” in s. 26(f) explored in [4.114]–[4.120] above. The interpretation of the word in Stanton (1955) 92 C.L.R. 630, McCauley (1944) 69 C.L.R. 235 and Sherritt Gordon Mines Ltd (1977) 137 C.L.R. 612 has left its meaning confined, among other respects, to a receipt for the use by another of property. Such an interpretation invites casting a transaction in a legal form which cannot be seen as involving a receipt for the use of property. Aktiebolaget Volvo (1978) 78 A.T.C. 4316 may be an example. The receipts in that case were in legal form for the giving of the keep-out covenant by Volvo Sweden, because they were expressed to be the consideration for that covenant.

4.235 If one assumes that the interpretation of the word “royalty” by the courts has given effect to the legislative intention, form and substance approaches to the application of the Act coalesce. One might wish to disagree with the finding of legislative intention, but this is a disagreement which can best be expressed by asking for a new expression of legislative intention in an amendment to the Act.

4.236 There is, however, a vital difference between specific provisions going to the meaning of income, and the meaning of income supplied by the ordinary usage notion. The ordinary usage notion needs to be expressed in judicial decision, but the expressions, though made in terms of legal art, should never be taken to be the definitive formulation of the ordinary usage notion. There is simply no basis for saying that the judicial decisions reflect the legislative intent. The legislature has given the courts the function of expressing ordinary usage, not the function of displacing that usage with their own. An expression of ordinary usage in a judicial decision may afford a useful rule, but it must always be subject to principles which, when expressed at all, must be expressed in the broadest of terms, none intended to be terms of legal art.

4.237 It follows that where the issue is whether an item is income in the ordinary usage meaning of the word, a resort to substance will always be appropriate. In a number of paragraphs ([2.410]–[2.412], [2.420]–[2.428] above) concerned with the ordinary usage meaning, attention was drawn to a form approach, in favour of, or against the taxpayer, in judicial decisions. A form approach will rely on some expression of the ordinary usage meaning in a rule which appears to invite the adoption of a legal form which will engage or escape the operation of the ordinary usage notion of income. The rejection of such an approach by Megarry J. in Pritchard v. Arundale [1972] 1 Ch. 229 where its adoption would have produced a
conclusion that the taxpayer had derived income, when the substance of ordinary usage directed that he had not, may be thought to be beyond question. The approach rejected by Megarry J. was also rejected by the High Court in *Dickenson* (1958) 98 C.L.R. 460, where its effect may have been to favour the taxpayer. In fact the characterisation by reference to all the circumstances, in the application of a substance approach, produced an outcome favourable to the taxpayer in any event.

4.238 A form approach may be equally inappropriate where issues other than the characterisation of an item as income are to be resolved. Thus, a form approach may be thought inappropriate where the question is whether an item has an Australian source. Here too the function of the courts, where there is no specific provision, is to find principles which can only be formulated in the broadest of terms, none intended to be terms of legal art. A recognition that this is their function is implicit in the frequent quotation of words from the judgment of Isaacs J. in *Nathan* (1918) 25 C.L.R. 183 at 190: “The ascertainment of the actual source of a given income is a practical, hard matter of fact.” The words quoted are clearly not intended to be taken literally—a matter of fact is a matter of what the facts are, a matter of source must be a matter of a legal conclusion from those facts. But the words emphasise that the legal conclusion is a matter of characterisation in terms of broad principles which will take count of all the facts.

4.239 The courts have expressed the notion of source in a number of rules which appear to invite the adoption by the taxpayer of a legal form which ensures that income does not have an Australian source, and there are occasions when a form approach has been taken to support the taxpayer. *Atkiebolaget Volvo* (1978) 78 A.T.C. 4316, referred to above, may afford an illustration. One rule expressing the notion of source suggested by the authorities, is that a source in Australia is given by the fact that the receipts are for the use of property in Australia. The conclusion reached by Jenkinson J. that the receipts were not royalties depended on their form as receipts for a restrictive covenant. They did not have the form of receipts for the use of Volvo Sweden's goodwill in Australia associated with the name “Volvo”. Whatever the appropriateness of the form approach on the question whether the items were royalties, it ought not to resolve the question of source. The fact that goodwill in Australia was made exclusively available to Volvo Australia by the keep-out covenant in respect of which the payments were made, was, and should have remained, relevant. Jenkinson J. concluded that other factors required a conclusion that the source was not in Australia, but he appears to have taken the view that the making available of goodwill in Australia was irrelevant unless
“the agreement were to be characterised as an assurance to Volvo Australia of goodwill conceived as a species of Australian personal property” (at 4323), a characterisation he had already rejected in deciding that the receipts were not royalties.

4.240 If a form approach is inappropriate where the question is whether an item is income by ordinary usage, it is equally inappropriate where the issue is whether an item is deductible as within the general provision in s. 51. The matter is explored in Chapter 9 below. Section 51 seeks to formulate principles, a task left to the courts in relation to the meaning of income by ordinary usage. But the principles are expressed in the same broad terms as are expected of the courts in giving meaning to income. Since the decision in Cecil Bros Pty Ltd (1964) 111 C.L.R. 430, the High Court has taken an approach to the application of s. 51 which bears comparison with the form approach to the application of s. 26(f) taken in Volvo. While it has been conceded that the form approach may be appropriate in the application of s. 26(f), it is clearly inappropriate in the application of s. 51. The approach in Cecil was confirmed by the Privy Council in Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2) (1976) 76 A.T.C. 6001. Both cases involve the assertion of a rule that the costs of trading stock are deductible, a rule which is not to be found in the Assessment Act: s. 51(2) does not so provide. That rule is then treated as sovereign in requiring a conclusion that a payment which a taxpayer is bound to make under a contract by which the consideration received for the payment is solely the supply of trading stock, is deductible. That the contract is relevant to the characterisation as deductible or not deductible would not be denied. But it is only one of the circumstances that is relevant in reaching a conclusion as to the operation of the principles expressed in s. 51. To insist that the Commissioner and the courts must wear blinkers and treat circumstances as irrelevant which are evidently relevant to the operation of those principles, is to subvert the Assessment Act. It is necessary to look at the “substance” of the matter, which is to say that in this area the intention of the Act is that tax consequences are not solely dependent on the legal forms that have been followed, as may be the case where the Act is in its terms framed in language that uses words of legal art.

4.241 Some retreat from Cecil and Europa Oil (No. 2) may be evident in the judgments in South Australia Battery Makers Pty Ltd (1978) 140 C.L.R. 645, though that case qualified the form approach only to a degree and in a way which left the principles of s. 51 defeated—one is entitled to look to an advantage which in fact is gained by a third party as a result of the payment, if that advantage enures in its consequence to the taxpayer.
The advantage will be irrelevant if it is confined to the third party, and this even though the third party is an associate of the taxpayer.

4.242 What is called for is not some qualification on the form approach but its abandonment in the application of s. 51.
Part II: Allowable Deductions: The Reduction of Assessable Income to Taxable Income
Chapter 5: The Framework of Section 51 of the Assessment Act

The Setting of Section 51

5.1 In [1.1]-[1.9] above the general framework of the Assessment Act by which taxable income is determined and tax is levied on taxable income was explained. “Taxable income”, as defined in s. 6, is “the amount remaining after deducting from assessable income all allowable deductions”. Allowable deductions reduce the amount of assessable income on which tax is levied, and thus reduce the amount of tax. The amount of tax will depend on the applicable rates of tax, as explained in [1.1] above. It will also depend on the credits against tax that may be available to a taxpayer, for example under Div. 18 (credit in respect of tax paid in Papua New Guinea), under s. 45 (relating to tax paid in a foreign source on dividends), or under the *Income Tax (International Agreements) Act* (relating to tax paid in a number of countries with which Australia has double tax agreements). The amount of tax will depend on deductions from tax, for example the deduction provided for in s. 100 where tax is levied on the assessable income of a beneficiary in a trust after an assessment has been made on the trustee, as representing the beneficiary, under s. 98. And it will depend on rebates of tax which may be available to the taxpayer, for example the rebate on dividends received by a shareholder that is a company under s. 46, and the concessional rebates under Div. 17 of Pt III, which relate the amount of tax to the personal circumstances of the taxpayer.

5.2 In general these allowable deductions, credits against tax, deductions from tax and rebates of tax are available only where the circumstances involve the derivation of income. But there are important exceptions. The most important are the concessional rebates. And there are some allowable deductions, for example the deduction for gifts made to certain charities (s. 78), the deduction in respect of home insulation expenditure (Subdiv. E of Div. 3 of Pt III) and the deductions for contributions to superannuation schemes by self-employed persons and certain employed persons (Subdiv. AB of Div. 3 of Pt III) which do not relate to the derivation of income.

5.3 Part II of this Volume is primarily concerned with allowable deductions that relate to the derivation of income, more especially with the allowable deductions which depend on the general provisions of s. 51. The method of Part II is to deal at length with s. 51, explaining its framework and operation and drawing out the fundamental distinction between
expenses which are deductible under the section as working expenses and those which are not deductible because they are of a capital nature. The specific provisions of the Assessment Act which allow deductions are then considered. Some of these provisions, for example s. 53 relating to repairs, may confirm, extend, limit or modify the principles contained in s. 51. Other specific provisions provide for the deduction of expenses which would not be deductible under s. 51, because they are of a capital nature. A number of them are of general application, for example ss 54–62 which relate to deductions for depreciation, and allow deductions of the cost of a wasting capital asset as that cost is consumed in the process of deriving income. One set of provisions of general application, Subdiv. B of Div. 3 of Pt III (investment allowance) allows a deduction of part of the cost of a wasting capital asset when that cost is incurred. It allows the deduction in addition to any deductions by way of depreciation. In this instance the function of the deduction is not to allow a cost of deriving income, but to give an incentive, by way of tax relief, to encourage certain investment action by the taxpayer.

5.4 Some specific provisions relate to particular industries: mining (Div. 10 of Pt III), transport of certain minerals (Div. 10AAA of Pt III), prospecting and mining for petroleum (Div. 10AA of Pt III), timber operations (Div. 10A of Pt III) and Australian films (Div. 10BA of Pt III). They may allow immediate deduction of expenses that would probably not be allowable under s. 51 because they are of a capital nature (for example minerals prospecting expenditure), or allow deduction of the cost of wasting capital assets on a more generous basis than that allowed by the general depreciation provisions. These provisions may be seen as giving favoured treatment to the industries concerned. The favoured treatment amounts to subsidies to those industries. There is a body of opinion, which would question the general appropriateness of providing subsidies indirectly through tax relief. The matter is considered in the Asprey Report (Taxation Review Committee, *Full Report*, A.G.P.S., Canberra, 1975, Ch. 3, paras 23–26).

5.5 The fact that the provisions of the Act applicable to a particular industry appear more generous when compared with those generally available does not always require a conclusion that the provisions are subsidy or “tax incentive” provisions. There are industries where the general provisions may not operate fairly to give deductions of the cost of wasting capital assets, and special provisions may be necessary. This was the view of the Asprey Committee in making recommendations for changes in the provisions relating to the mining industry. There can be no question, however, that the Australian films provisions in Div. 10BA of Pt
III are subsidy provisions.

5.6 The investment allowance provisions referred to in [4.3] above and in [10.421]–[10.423] below, in allowing a deduction additional to depreciation, give a deduction for a notional expense. There are other illustrations of deductions for notional expenses. The provisions of ss 80ff. allowing the deduction of a loss carried forward from an earlier year of income, may be seen in this way. The deduction is of the amount of the negative income of an earlier year—the excess of expenses of that year over the income of that year. The deduction serves to correct the unfairness that would otherwise arise under a tax system which determines the income subject to tax by reference to a period of one year—the year of income. The deduction for an income equalisation deposit provided for in Div. 16C of Pt III had a similar function.

The Framework of Section 51

5.7 The provisions of s. 51(1) call for the close examination that follows, extending over this chapter and Chapters 6, 7, 8 and 9 below. The subsection provides for the deduction of “losses and outgoings”, words which may have distinct meanings, “to the extent to which they are incurred”. Apportionment is contemplated and there is a notion of incurring which is parallel with the notion of derivation in relation to income. Losses and outgoings are deductible where they are “incurred in gaining or producing assessable income”, or where they are “incurred . . . in carrying on a business for the purpose of gaining or producing such income”—the alternatives are referred to as the two “limbs” of s. 51(1). The subsection then proceeds to except losses or outgoings “to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income”.

5.8 There is one aspect of this framework that requires examination at the outset: are the exceptions in the concluding part of s. 51(1) true exceptions, or are they simply statements of what must be distinguished from items which qualify for deduction under the earlier part of the subsection? The issue is between true exception and contradistinction. The issue has been the subject of some judicial debate, more especially in the High Court in John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 and in Forsyth (1981) 148 C.L.R. 203 and Handley (1981) 148 C.L.R. 182. There is no judicial decision, however, in which it has been held that an item was prima facie deductible under one or other of the limbs of s. 51(1), yet was excluded from deduction by one of the exceptions. Clearly one of the exceptions is
by way of contradistinction only—the exception of losses and outgoings incurred in relation to the gaining or production of exempt income. In *Fairfax* Dixon C.J. drew attention to the fact that an item within this exception could not be within one or other of the limbs, since each is concerned with losses and outgoings incurred in relation to the gaining or producing of assessable income.

5.9 What is clear in the case of the exempt income exception may not be thought so clear in the cases of the capital and private or domestic exceptions. But the fact that the exempt income exception is by way of contradistinction at least suggests that the other exceptions have the same function. And there are reasons in logic and good sense why the other exceptions should be regarded as stated only by way of contradistinction. It will be noted that the exceptions repeat the words “to the extent to which” that appear in the earlier part of the subsection. If the exceptions are true exceptions it is necessary to contemplate that there may be a loss or outgoing which is in part within one of the limbs and that some part of that part may be denied deduction by the operation of one of the exceptions. Such a framework, while logically conceivable, becomes conceptually so complex as to be unmanageable. It is no less logical to read the second use of the phrase “to the extent to which” with the first use of that phrase, so that the intention is merely to emphasise that to the extent that an outgoing is not within one of the limbs, it will be denied deduction because it is capital, private or domestic. The observation by Aickin J. in *Handley* (1981) 148 C.L.R. 182 at 200 that s. 51(1) “does not require a two-stage apportionment” is a denial that the capital and private or domestic exceptions are true exceptions.

5.10 The good sense in reading the exceptions as intended only to distinguish will appear from the examination of the interpretation and application of the earlier part of the subsection which makes up much of this and following chapters. It will be seen that the pervasive idea that will explain why a loss or outgoing is within one of the limbs is that it is a “working”, “constant demand”, “operating” or “maintenance” loss or outgoing. Such losses or outgoings are contrasted in the judicial decisions with “capital” or “structural” losses or outgoings. The adoption of a view that a capital loss or outgoing may be a special kind of an expense (the word is used hereafter to cover both losses and outgoings) within one of the limbs, would require a rewriting of much of the volumes of decisions on the interpretation and application of s. 51(1).

5.11 It is true that the judicial decisions are not locked in to language which would exclude the possibility that an expense is at once a working expense and a private or domestic expense. There are, indeed, judicial
observations in Forsyth and Handley, and in other cases, that some expenses are “essentially private”. What is intended by such observations is not always clear. One possibility is that it is intended to assert that expenses which relate to such matters as the provision of food, shelter, or medical treatment for oneself, or the expense of travel between a work place and one's home, are necessarily private and are to be denied deduction, however much they are relevant to the derivation of income. If this is the intention, the commercial traveller will be put at a severe disadvantage. It would be a disadvantage that is quite without any sense. This is not to say that expenses that relate to the provision of food, shelter and medical treatment for oneself should be readily found to be working expenses. If they are readily found to be working expenses, the application of the Assessment Act will have moved significantly towards becoming a tax only on income saved. The same observations might be made in relation to expenses of travel between a work place and one's home.

5.12 The view adopted in this Volume is that the exceptions in s. 51(1) operate only by way of contradistinction. Accepting this analysis, the effect of s. 51(1) is to allow the deduction of expenses relevant to the derivation of assessable income, to the extent that they are working expenses, and are contemporaneous with activity whence income is derived, or with the holding of property for the derivation of income. Such a statement of the effect of s. 51(1) may obscure some of the problems of interpretation, but it is helpful in asserting the irrelevance of the meanings of “capital” and “private or domestic”, save so far as they may identify the reason that an expense is not a working expense. Where an expense is relevant to the derivation of income, to say that it is capital is to say that it is not working because it relates not to the process by which income is derived but to the structure of the activity that produces income, or to the property itself whence income is derived. Where an expense is not relevant to the derivation of income, to say that it is capital gives no more reason why it is not a working expense than may be given by saying that it is a private expense. It may be an accepted use of words to describe the expenses of extending the house in which one lives as capital, and not so to describe the expenses of maintaining the house. Such a use of the word is not significant for the operation of an income tax, however significant it may be for the operation of a capital gains tax. What is significant for income tax purposes is that the expense is not relevant to the derivation of income. The want of relevance is sufficiently stated by saying that the expense is “private or domestic”.

5.13 In summary, on the analysis adopted:
(i) A non-contemporaneous expense is not deductible under s. 51(1) whatever its nature.

(ii) A contemporaneous expense is deductible if it is a working expense, and relates to assessable income as distinct from exempt income. No other contemporaneous expense is deductible under s. 51(1).

(iii) An expense that is relevant to income derivation will be a working expense if it relates to the process by which income is derived. It will not be a working expense, and may be described as a capital expense, if it relates to the structure of the activity that produces income, or to the property whence income is derived.

(iv) An expense that is not relevant to income derivation will not be a working expense, and may be described as a private or domestic expense.

The distinction between outgoing and loss

5.14 The words used in s. 51 to identify the items with which the section is concerned are “losses and outgoings”. There has been very little discussion in the cases of what may have been intended by the use of these words. At times the words are quoted as if they were interchangeable. Whatever its overlap in other respects with “outgoings”, “loss” must have a distinct meaning in order that s. 51 might provide for the deduction of a specific loss where a specific profit would be income by ordinary usage.

5.15 The view that the Assessment Act is concerned only with “receipts” and “outgoings” save where specific provisions, such as s. 25A and s. 52, provide otherwise, was examined in Chapter 1. A contrary view was taken: a gain that is income by ordinary usage may be a specific profit—the balance of proceeds over cost. Where this is so, there must be provision for the allowance of a specific loss, if loss and not profit is the outcome. The situations where specific profit is the item of income may be summarily stated thus:

(i) A business of investing where the investments are revenue assets, but are not trading stock and thus subject to Subdiv. B of Div. 2 of Pt III—the situation in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106 as seen by Gibbs J. ([2.465]–[2.466] above).

(ii) A business of banking or life insurance where investments may need to be realised in order to meet the claims of depositors or policy holders: whether this is a situation distinct from (i) may be thought to be left open by London Australia ([2.467]–[2.477] above).

(iii) The holding of an asset which is a revenue asset, in circumstances other than (i) and (ii), when the asset is not trading stock and thus subject to Subdiv. B of Div. 2 of Pt III. The principal illustrations involve contracts under which the taxpayer may be entitled to the supply of goods or services by another, or contracts under which he is entitled to supply goods or services to another, or contracts under which the taxpayer is entitled to use the property of another ([2.488]–[2.489] above). Another
illustration is spare parts held for use in the repair of assets of a business. There may be further illustrations if the definition of trading stock in s. 6 is held not to cover the particular item and the taxpayer trades in the item. In fact the definition has been interpreted so extensively by the decision in *Investment & Merchant Finance* (1971) 125 C.L.R. 249 and *St Hubert's Island Pty Ltd* (1978) 138 C.L.R. 210 that it may now be thought that anything can be trading stock, but *St Hubert's Island* leaves open the possibility of some limitation. The contracts referred to must be revenue assets. The distinction between a revenue asset and a capital or structural asset was explained in [2.478]–[2.491]. Where a contract is a revenue asset, the distinction between a specific profit that is income, and a receipt that is income, becomes blurred. The courts have been disposed to allow the immediate deduction of the cost of a wasting revenue asset, that is, a revenue asset whose cost may be said to be consumed in the derivation of income. Thus, immediate deductions of the cost of the arrangement entered into by the taxpayer oil company was assumed to be the correct application of principle in *B.P. Australia Ltd* (1965) 112 C.L.R. 386, though there is some discussion in the contemporaneous decision in *Strick v. Regent Oil Co. Ltd* [1966] A.C. 295 whether it might not be appropriate to spread the cost forward over the period of the tie. If an immediate deduction of cost is allowed, it is not helpful to insist that the realisation of the asset—which may include a surrender of the rights it affords—is an occasion when specific profit is the appropriate item of income. Section 82 will preclude the subtraction, in computing any profit, of an amount that has been allowed as a deduction. If, however, it should come to be held that the correct application of principle is to require that the cost of a wasting revenue asset should be spread forward, it will be helpful to insist that the realisation of the asset is an occasion when specific profit is the appropriate item of income. So much of the cost as has not been allowed as a deduction will then remain to be subtracted in computing the profit if the asset is realised.

(iv) The holding of a receivable on revenue account in respect of which there may be a receipt which exceeds the cost of the receivable. The cost will generally be the amount at which the receivable was brought to account as assessable income by an accruals basis taxpayer, but it need not be. The receivable may be money lent by the taxpayer who is in business as a money lender. Or it may be money otherwise lent on what may be described as revenue account—a loan made by a taxpayer under a scheme to provide financial assistance to employees, or to a supplier of goods, or to an outlet for the taxpayer's production. The gain may be the element of premium received on an early repayment of the loan. Whether the receivable arises from the supply of goods or services or the loan of money, the gain may be the result of a variation in the rate of exchange if the receivable is in a foreign currency ([6.309]–[6.330] below).

(v) The holding of a liability on revenue account. Explanation of that concept is included in [6.222]ff. below.

5.16 The view that the word “loss” in s. 51(1) is intended to provide for the deduction of a specific loss, where a specific profit would be income, is in some conflict with a number of observations made by Gibbs J. in *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616 at 629. Gibbs J.
sought to limit the significance of an observation he had made in International Nickel Australia Ltd (1977) 137 C.L.R. 347 at 352 that “where the income of the taxpayer is derived from trade there is not really a difference between the concept of income and that of profit”. He insisted that the observation was to be confined to the determination of income, and that, once income has been ascertained, the view of Dixon C.J. in Caltex Ltd (1960) 106 C.L.R. 205 at 218 must prevail: “[whether a deduction is allowable] is not a matter depending upon proper commercial principles or accountancy practice but on the legal criterion set by s. 51(1).” If commercial or accounting practice as to the determination of a profit are relevant to the conclusion that an item of profit is income, as Gibbs J. thought they were in International Nickel, it is hard to see why they should cease to be relevant if the item of deduction is a loss. There must be a deduction for a loss if circumstances otherwise the same as in International Nickel give rise to a loss rather than a profit. And if the loss is deductible, it must be so under s. 51(1), for no other provision would make it deductible.

5.17 The case on deductibility in relation to events which involve a taxpayer being deprived of an asset reflect a less than adequate analysis of the significance of the use of the word “loss” in s. 51(1). The cases are considered in [6.52]–[6.77] below. A taxpayer may be deprived of an asset because it has been taken from him by another (an employee or a third party) or by its destruction. Whatever the cause of deprivation, the item of deduction, if any is allowable, is the loss suffered in the sense of the failure of the asset to realise its cost. Where a revenue asset, such as a spare part held for use in making repairs to assets of a business, is destroyed and there is no residual value in the scrap, there will be a deduction of a loss in the amount of the cost of the spare part. The item of deduction is not the value of the item, and any suggestion that it is involves a confusion between the word loss in its usage in s. 51(1) and its usage in a phrase such as “the taxpayer suffered the loss of a quantity of spare parts by their destruction in enemy action”. The judgments in Guinea Airways Ltd (1950) 83 C.L.R. 584 do not clearly differentiate these distinct usages, though the usage in the sense of the correlative of specific profit is implicit in the assumption that the appropriate deduction was the cost of the spare parts, not their value at the time the taxpayer was deprived of them by destruction.

5.18 Where the property of which the taxpayer is deprived is cash, the appropriate item of deduction will be the amount of the cost of the cash. Save where the cash is in foreign currency, the cost may be taken to be the amount of the cash, and there will be no difference in the amount of the deduction whether the item of deduction is seen as a loss by failure of the asset to realise its cost or as an outgoing of the amount of the cash. But the
characterisation of the item as a loss by failure of the asset to realise its cost focuses the question on the nature of the holding of the cash—whether it is held on revenue account, on capital account or on private account.

5.19 The view that the word “loss” in s. 51(1) refers to the failure of an asset to realise its cost does not exclude the possibility that the word may be used in the sense of outgoing by deprivation in other sections of the Act. Section 59, for example, in the reference to property in respect of which depreciation has been allowed being “disposed of, lost or destroyed”, uses the word “lost” to refer to a deprivation, presumably a deprivation by being unable to find the property. Yet the deduction allowed, it should be noted, is akin to the deduction of a loss under s. 51(1). It is a deduction of the depreciated value of the property, generally the cost of the property moderated by any consideration receivable in respect of the loss by deprivation.

5.20 These uses of the word “loss”—to refer to the failure of an asset to realise its cost and to refer to the deprivation of an asset—must be distinguished from another use of the word. In ss 80ff. provision is made for the deduction, against assessable income of later years, of a “loss” being the amount of the excess of allowable deductions over assessable income in an earlier year. The word loss in this context has its parallel in the negative balance of a profit and loss account in financial accounting. The reference is not to a specific loss in relation to some asset, but to a failure during a year of income to generate assessable income at least equal to the expenses of that year, expenses which may include specific losses.

5.21 It is apparent from the cases on exchange losses that the word “loss” in s. 51(1) covers both the failure of an asset to realise its cost, which has so far been assumed to be the meaning of the word in the subsection, and the discharge of a liability by paying an amount greater than the amount at which that liability has been brought to account as a deduction by an accruals basis taxpayer, or the amount acknowledged to be payable in respect of a borrowing on revenue account. The deduction for a loss in these circumstances, is the correlative of the inclusion in income of a specific profit on the discharge of a liability on revenue account.

5.22 The reference in s. 51(1) to a “loss” incurred is a reference to a realised loss. No deduction is allowable under s. 51(1) comparable with the deduction for an unrealised loss by way of depreciation in s. 54ff.

Outlay and outgoing

5.23 References under the last heading to the distinction, within expenses deductible under s. 51(1), between outgoing and loss raise a question of the
reason for the non-deductibility as an outgoing of a cost that will enter the
determination of a specific profit which is income, or a specific loss which
is deductible.

5.24 Section 51(2) provides that the “expenditure incurred or deemed to
have been incurred in the purchase of stock used by the taxpayer as trading
stock shall be deemed not to be an outgoing of capital or of a capital
nature”. It is assumed that the effect is to ensure the immediate
deductibility of the cost on the purchase of trading stock. Such a deduction
is necessary if the trading stock provisions in ss 28ff. are to operate fairly.
An increase in the value of trading stock on hand at the end of a year of
income over trading stock on hand at the beginning of a year of income
must be included as assessable income. The value of trading stock acquired
during a year which are still on hand at the end of the year will therefore
increase the assessable income. The intention is that the cost of acquiring
such stock will be deferred, by this increase in assessable income, to the
next year of income or a later year when the stock is sold. The mechanism
of s. 28 requires that there be a deduction on which the deferral can
operate. Section 51(2) seeks to ensure that there is such a deduction, by
removing what was thought to be the reason for denying such a deduction.
The subsection is not happily expressed. It led to some speculation by
Dixon C.J. in John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 at 35 who
inclined to the view that the cost of trading stock would not in any case be
regarded as being of a capital nature. It is clearly not of a capital nature in
the sense explained later in this and following chapters. It does not relate to
the structure of the business, unless stock has been acquired beyond any
holding for sales in the ordinary course of business: at some point the
acquisition of stock could relate to structure for the same reason that the
acquisition of an abnormal quantity of spare parts was held to relate to
structure in some of the judgments in Guinea Airways Ltd (1950) 83
C.L.R. 584. The acquisition of trading stock to be sold in the ordinary
course of business is a capital outgoing only in the sense that the cost
should be “capitalised”, the word being thus used in an accounting sense to
refer to costs which should not have any present effect on the profits of a
business. Section 51(2) would have avoided using the word capital in a
sense different from its use in s. 51(1), had it simply provided that
expenditure on trading stock shall be deemed to be an outgoing for
purposes of s. 51(1). Without some such provision, the cost of trading
stock, like the cost of other revenue assets which are non-wasting, would
not be deductible under s. 51(1). The word outgoing, it is submitted,
connotes an outlay which is consumed or will be consumed in the process
of derivation of income. The cost of a non-wasting revenue asset involves
an outlay, if that word is used simply to denote the payment of money or the transfer of other property, but not an outgoing. The cost of the non-wasting asset may be equated with the outlay of a $10 note in exchange for 10 $1 notes. The outlay will not be consumed in the process of derivation of income.

5.25 The need to accept the proposition that the cost of a non-wasting asset is not an outgoing and is not deductible under s. 51(1), may be demonstrated by considering the consequences of a contrary proposition if shares and land had not been held to be items which fell within the definition of trading stock in s. 6 of the Assessment Act. A trader in shares or land would need only to consider his likely taxable income at a time near the end of the year of income, and make purchases of shares or land whose cost would equal his anticipated taxable income. He would in the result have no taxable income, and by repeating the same operation each year could accumulate wealth but never have any taxable income. An awareness of this consequence may have disposed the High Court in Investment & Merchant Finance Co. Ltd (1971) 125 C.L.R. 249 to hold that shares could be trading stock, so that the mechanism of s. 28 would operate to require that a deduction of the cost of the shares would, in effect, be deferred to the year of income in which they were sold. But this way out is not available where an item cannot be brought within the mechanism of s. 28. It will not be possible in the circumstances of London Australia Investment Co. Ltd (1977) 138 C.L.R. 106 and in the other circumstances listed in [5.15] above. In those circumstances the assertion that specific profit is the item of income carries the consequence that the cost of the item is not deductible as an outgoing.

5.26 It must be conceded that the identification of a cost which is an outlay but not an outgoing, may pose difficulties of the kind that have to be met in the operation of the trading stock provisions in deciding whether costs of trading stock which are not direct are to be treated as costs that must be deferred by the mechanism in s. 28. The difficulties are a consequence of an insistence by the Commissioner on what is referred to as “absorption” costing: Philip Morris Ltd (1979) 79 A.T.C. 4352.

The two limbs of section 51(1)

5.27 The two limbs of s. 51(1) are:

“(i) All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income . . . shall be allowable deductions; and
(ii) All losses and outgoings to the extent to which they . . . are necessarily incurred
in carrying on a business for the purpose of gaining or producing such income . . . shall be allowable deductions.”

5.28 The words “to the extent to which” and the second limb were added to the general deduction section in 1936. The significance of the words “to the extent to which” is the subject of some comment later in this chapter. The intention in the adding of the second limb, according to an observation in Ronpibon Tin N.L. (1949) 78 C.L.R. 47 at 55 was to overcome a view that an outgoing whose purpose is to reduce future expenses—by achieving economies and greater efficiency—is not deductible under the first limb. However, W. Nevill & Co. Ltd (1937) 56 C.L.R. 290 is authority that this view was always mistaken.

5.29 The second limb is confined in its operation to expenses incurred in carrying on a business. “Business” is defined in s. 6 so that it will include activity which would amount to a business for purposes of the ordinary usage principle expressed in Chapter 2 as Proposition 14 ([2.429]ff. above), so far as that principle relates to what is there identified as a continuing business. It will not however include the simple holding of property whence income is derived. And s. 6 expressly excludes “occupation as an employee”.

5.30 The second limb of s. 51(1) would however appear to overcome the difficulties which attend the use of the word “the” before “assessable income” in the first limb of s. 51. Though endeavours have been made in the cases—in Ronpibon (1949) 78 C.L.R. 47 at 56, in the judgment of Dixon C.J., in Finn (1961) 106 C.L.R. 60 and in other judgments referred to by Lockhart J. in Total Holdings (Aust.) Pty Ltd (1979) 79 A.T.C. 4279 at 4282—to read the word “the” so far as possible out of the first limb of s. 51, there may yet be room for a submission that the first limb does not justify a deduction where the income-earning activity, or the holding of property to which the outgoing relates, has not produced any assessable income in the year of income in which the deduction of the outgoing is claimed. It is arguable that interest is not deductible where it is interest paid on a loan of money which has been invested in shares, if no dividend has yet been received or no dividend has been received in the year of income. If the second limb is attracted, the limitation suggested on the operation of the first limb will be escaped. At least this will be so if the word “such” before “income” in the second limb is taken to refer to assessable income in general, as is suggested in Ronpibon (1949) 78 C.L.R. 47 at 56 and in Snowden & Willson Pty Ltd (1958) 99 C.L.R. 431 at 436, per Dixon C.J.

5.31 Where the income-earning activity to which the deduction relates has
generated assessable income in the year of income in which the deduction is claimed, it would not appear that the second limb carries the range of deductible outgoings beyond the first limb. There is, it is true, some suggestion in the judgment of Fullagar J. in Snowden & Willson at 443 that the second limb does extend the range of deductible outgoings in one respect: it may cover business expenditure “arising out of exigencies created by unusual or difficult circumstances” which, the suggestion is, would not be covered by the first limb. The suggestion is also made by Fullagar J. in his judgment in John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 at 40.

5.32 The word “necessarily” in the second limb might have been construed so as to limit the operation of the limb in a way not applicable to the first limb. It has, however, been construed as requiring no more than that the expense should be “clearly appropriate” or “adapted” for the carrying on of the business (Ronpibon (1949) 78 C.L.R. 47 at 56; Snowden & Willson Pty Ltd (1958) 99 C.L.R. 431 at 436-7 and 444). In Snowden & Willson Dixon C.J. at 437 interpreted the word “necessarily” as meaning “dictated by the business ends to which [the expenditure] is directed, those ends forming part of or being truly incidental to the business”. The connection with the derivation of income required by the second limb, would not appear to be any closer in this regard than that required by the first limb.

5.33 Whether the applicability of the first limb or the second limb is in question, the inquiry must be concerned with the connection between the expense and the particular process of derivation of income. It is for this reason, and not because he does not have available to him the words in the second limb, that an employee may appear to be less favourably treated than the self-employed person. The different treatment of the employee compared with the self-employed person, for example, in relation to self-education expenses, is considered in [8.38]ff. below.

Matching of expenses and income

5.34 Whichever limb the taxpayer relies upon, it is not necessary for him to show that in the year of income there was assessable income, or that there was an expectation of assessable income, with which the outgoing can be matched. In the language of Ferguson J. in Toohey's Ltd v. C. of T. (N.S.W.) (1922) 22 S.R. (N.S.W.) 432 at 440, it is not necessary to “track each item of expense . . . and allocate it to some definite item of income”, as if to determine that a “lump of coal put into a steamer's furnace was responsible for a particular blast from the whistle”. The tracing of self-education expenses into increased salary proposed by Menzies J. in
Hatchett (1971) 125 C.L.R. 494 as a test of deductibility may be seen as simply one test of relevance and thus reconcilable with Toohey. On other occasions, however, a “blast from the whistle” approach does appear to have influenced judicial decision. In Chapkhana (1977) 77 A.T.C. 4412 Wickham J. supported his conclusion that premiums on a personal disability policy taken out by an employee were not deductible by saying: “there is no sufficient reason for concluding that the occasion of the outgoing constituted by the premiums is such as would be expected to produce income” (at 4414). His reason adopts some of the language of Ronpibon (1949) 78 C.L.R. 47 at 57 where the High Court said: “the occasion of the loss or outgoing should be found in whatever is language. Tracing has, more recently, been expressly rejected by the Federal Court in Total Holdings (Aust.) Pty Ltd (1979) 79 A.T.C. 4279 at 4283, per Lockhart J.

5.35 It might, however, have been thought that s. 51 requires that an outgoing, to be deductible, must be matched with the income of the year of income, in the sense that it is an outgoing which accounting principles would regard as a proper charge against the income of that year of income in computing the profit of that year. But the courts have not held that, to be deductible, an outgoing need be so matched: Ronpibon (1949) 78 C.L.R. 47; Herald & Weekly Times Ltd (1932) 48 C.L.R. 113; W. Nevill & Co. Ltd (1937) 56 C.L.R. 290; Texas Co. (Australasia) Ltd (1940) 63 C.L.R. 382; and John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 especially per Menzies J. at 45–46.

5.36 Some matching does result, it will be seen in Part III, from the principle of tax accounting established in Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314 that a receipt is not income derived until it has been earned. The effect of this principle may be to delay the derivation of income until the year of income in which matching outgoings are incurred. But it seems that there is no principle of tax accounting which will require the deferring of an outgoing to the year of income in which matching income is derived. The Privy Council in B.P. Australia Ltd (1965) 112 C.L.R. 386 and the House of Lords in Strick v. Regent Oil [1966] A.C. 295 did not consider it appropriate to defer the costs of wasting revenue assets—contracts under which garage proprietors agreed to sell only the taxpayer's products—over the life of those assets. There is no principle of tax accounting which would allow the carrying back of a receipt or an outgoing to the year in which matching deductible outgoings or income receipts were incurred or derived. Such carrying back would in many cases be precluded in any event by the limitations on the Commissioner's powers to amend assessments under s. 170.
Temporal aspect of “in gaining” and “in carrying on”

5.37 Ronpibon and Amalgamated Zinc (De Bavay's) Ltd (1935) 54 C.L.R. 295 have drawn from the use of the words “in gaining” in the first limb and “in carrying on” in the second limb, a requirement that an expense to be deductible must be contemporaneous with the process by which income is derived. These cases emphasise that the outgoing must have been incurred “in the course of” the income-producing activity or the holding of the income-producing property to which the income relates. If the outgoing is incurred before that activity commences (Maddalena (1971) 45 A.L.J.R. 426) or before the property is acquired, or if it is incurred after the activity ceases (De Bavay's; Ronpibon; Pennant Hills Restaurants Pty Ltd v. Barrell Insurance Pty Ltd (1981) 145 C.L.R. 625, per Gibbs J. at 642) or the property is disposed of, it is not an allowable deduction. In the latter aspect the law as to deduction differs from the law as to when a receipt is income. A receipt which is a product of an income-producing activity or which is derived from property will be income notwithstanding that it is derived after the activity has ceased or the property has been disposed of. This is the assumption in Hayes (1956) 96 C.L.R. 47 and Squatting Investment Co. Ltd (1954) 88 C.L.R. 413.

5.38 In De Bavay's and Ronpibon the expenses were not deductible because the business had ceased. In De Bavay's the expenses—contributions to a fund to compensate employees who had incurred a disease associated with mining—were incurred at a time when the company had given up all thought of mining. And in Ronpibon, where the expenses included the payment of allowances to dependants of employees who were now interned by the enemy, the resumption of mining was impossible because the mines had been overrun by the enemy. In other circumstances, there may be some question as to whether the business has ceased. In A.G.C. (Advances) Pty Ltd (1975) 132 C.L.R. 175 it was held that the business had not ceased. It had merely been suspended. The expenses—losses in respect of bad debts—were incurred after the business had resumed, and the case does not decide how expenses during the period of suspension should be regarded. Queensland Meat Export Co. Ltd (1939) 81 St. R. Qd. 240 may indicate that expenses are deductible if the business is merely suspended. The distinction between cessation and suspension thus becomes important. It may be asked whether a business is merely suspended if it has ceased to be profitable to carry on business, as in the facts of Heavy Minerals Pty Ltd (1966) 115 C.L.R. 512 or if raw material supplies have become inadequate, as in Queensland Meat Export Co. Ltd, and plant is put on a care and maintenance basis. It is arguable that there is
a mere suspension if the taxpayer has the intention to resume operations when it is thought commercially appropriate to do so, though *Inglis* (1977) 77 A.T.C. 4305 may reject such an argument. There is a question of how *Ronpibon* is to be distinguished—in that case the resumption of operations, at least in the same country as that in which the former operations had been carried on, was physically impossible. *Ronpibon* involves a notion of business which is specific to particular assets: presumably the same view would have been taken in the case, in regard to the deduction claimed for the dependants' allowances, even though the company continued to operate a mine in Australia.

**5.39** Where there is a decision by the taxpayer permanently to cease operations, cessation does not necessarily occur on the taking of that decision: it is still possible that expenses of administration and maintenance are deductible pending realisation of the business assets: *I.R.C. v. South Behar Railway Co. Ltd* [1925] A.C. 476.

**5.40** In *A.G.C. (Advances)* the majority opinions (Barwick C.J. and Mason J.), while accepting the contemporaneity requirement, albeit with some reluctance, suggest that there may be a distinction to be drawn between an outgoing incurred after cessation, and a loss which though incurred after cessation, is in respect of an asset acquired before cessation. The deductions claimed in *A.G.C. (Advances)* were in respect of receivables that had arisen in the course of the business activity but had failed to realise their cost, as the Commissioner submitted, after the cessation of the business. It is arguable that a loss in these circumstances is more closely connected with the business activity than the payments to the fund in *De Bavay*’s, or the payments of the allowances in *Ronpibon*.

**5.41** Problems as to the moment of commencement of a business are no less than the problems as to the moment of cessation. A feasibility study, in the sense of a study to determine whether a decision to commence business would be sound commercially, comes too soon. At least this is so if one identifies “the business” for purposes of the contemporaneity principle as specific to a particular undertaking as in *Ronpibon*. Cf. *Broken Hill Pty Co. Ltd* (1969) 120 C.L.R. 240 at 258-60.

**5.42** An aspiring author who incurs expenses in collecting material for a book may be held to have incurred expenses which come too soon. The questions whether a business of authorship has yet commenced, and, if it has, when it commenced, will involve issues considered in [2.439]–[2.443] above. *Ferguson* (1979) 79 A.T.C. 4261 will have some bearing.

**5.43** The contemporaneity requirement, where the item is a pre-commencement expense, may be reinforced by the requirement that to be deductible an expense must be a working expense. A feasibility study may
be thought to relate to the structure of the business to be established rather than to the process of business operations, and for this reason not to be a working expense. A postcessation expense may be less likely to fail to qualify as a working expense, but *Foxwood (Tolga) Pty Ltd* (1981) 147 C.L.R. 278 may suggest the possible characterisation of an expense as not working because it relates to the closing down of the business.

5.44 The requirement of contemporaneity may defeat the allowance of a deduction where the expense relates to income derived from property. Interest payments on money borrowed to finance the erection of an office building for letting, and incurred before any part of the building is let, may be denied deduction as expenses incurred before the process of deriving income commences. The question raised is whether the process of deriving income commences at the time of a decision to build or only when at least part of the building is let. The answer may depend on whether the letting is an aspect of a business activity, and on the time when that business commences. There will be a question whether “business”, as the word is used in s. 51(1), has the meaning it has in ordinary usage principles (Proposition 14 in Chapter 2). The definition of the word in s. 6 may suggest that it does, and that is the view taken in this Volume. The judgment of Jones J. in *Somers Bay Investment* (1980) 80 A.T.C. 4411 may indicate that it has a wider meaning.

5.45 Payment of rates, repairs and interest expenses after the cessation of the letting of property may be denied deduction under s. 51(1) by the contemporaneity requirement. Again it will be relevant that the letting may be seen as part of a business of letting and that the business has not ceased. The contemporaneity requirement will of course only apply if the deduction is claimed under s. 51(1). Expenses of rates and repairs may be deductible under the specific provisions of ss 72 and 53. A deduction for rates is not allowable under s. 72 unless the amount “is paid in respect of land that is, or premises that are, used by the taxpayer during the year of income for the purpose of gaining or producing income or carrying on a business for the purpose of gaining or producing income”. The deduction for repairs under s. 53 is subject to a similar provision, though words requiring that the property be used “during the year of income” do not appear. In effect ss 72 and 53 have their own contemporaneity requirements, and may give rise to problems of interpretation. It may be asked whether a relevant use of land by the taxpayer at any time during the year of income is sufficient to satisfy the contemporaneity requirement, if the payment is made at a time when the land is not used in a relevant way. And it may be asked whether use by the taxpayer at any time will justify a deduction for repairs effected during a year of income. Subsection (3) of s.
53, added in 1984, may suggest that it will.

5.46 The requirement of contemporaneity may defeat the allowance of a deduction where the expense relates to employment income. The leading case is *Maddalena* (1971) 45 A.L.J.R. 426, where travel expenses were incurred in seeking a contract of employment to play football for a club, and legal expenses were incurred in relation to the making of that contract. The High Court contrasted the taxpayer's position with that of a self-employed plumber, who may incur expenses of obtaining contracts in quoting for work to be done. The self-employed person has already entered on an income earning activity. The person seeking employment has not. At least this is so, in the view of the court, if the employment will involve a contract of service, as distinct from a contract for services.

5.47 The technicalities of that distinction might have been thought remote in resolving the broad issue of principle posed by s. 51(1). *Maddalena* could have been decided on the basis that the expenses were not working expenses. They were capital as expenses relating to the structure of the income-earning activity—the contract of employment. The contract was a structural asset, as distinct from a revenue asset. A contract of service will normally be a structural asset, though *C. of T. (Vic.) v. Phillips* (1936) 55 C.L.R. 144, in the judgment of Starke J., suggests the possibility that a contract which is one of a number of contracts of service entered into by the same person may be a revenue asset of a business of providing services under contracts of service. At the same time, a contract for services may be a capital asset of a business of providing services. The discussion in [2.384]–[2.385] above is relevant. The result in *Maddalena* would, presumably, have been the same had it been approached not in terms of contemporaneity but in terms of the distinction between structural and working expenses. The approach in fact taken leaves a suggestion of a disadvantage imposed by s. 51(1) on a person who derives income under a contract of service. There is a reinforcement of the suggestion of discrimination already present in the words of the subsection, which confine the second limb to “business” situations, and in the definition of “business” in s. 6 so as to exclude “occupation as an employee”—the latter words, it would be assumed, refer to activity under a contract of service.

5.48 A consequence of *Maddalena* is that the payment of a periodical subscription in respect of the taxpayer's membership of a trade or professional association, made in anticipation of entering a sole contract of service, is not deductible under s. 51(1). It may be deductible under the specific provision in s. 73(3), which does not impose any test of contemporaneity, though it is narrower in other respects than s. 51(1). Another consequence of *Maddalena* is that the payment of a periodical
subscription at a time when the taxpayer is not employed under a contract of service—is “unemployed”—is not deductible under s. 51(1). The case, indeed, leaves one to doubt the wisdom of a contemporaneity rule. It may yet be possible for a court to hold that the absence of contemporaneity is no more than an indication that an expense is not relevant. Which will leave room for a conclusion that other factors may give relevance to a non-contemporaneous expense.

**Expenses relevant to the derivation of assessable income**

5.49 The view of the framework of s. 51(1) explained in [5.7]–[5.13] above, has the consequence that, to be deductible, an expense must be relevant to the derivation of assessable income, and must be a working expense. These two elements tend to be run together in much of the judicial elaboration of the operation of s. 51(1). It is summed up in the phrase “incidental and relevant”. The phrase is unhelpful, to the extent that it places the two elements out of their logical order. The first issue must always be whether the expense is relevant. If it is not, it is not deductible. It may be described in this event as “private or domestic”, though the appropriateness of such a description is not an issue of itself going to deductibility. If the expense is relevant, it will be deductible if it is a “working expense”—a phrase which is more expressive of the criterion than “incidental”. Other expressions of the criterion are “constant demand”, “operating” or “maintenance”. If a relevant expense is not a working expense, it may be described as “capital”.

5.50 To be deductible under s. 51(1) an expense must be relevant to the derivation of assessable income. The requirement of relevance to assessable income is emphasised by the contradistinguishing exception of expenses relevant to the derivation of exempt income. The requirement of relevance to assessable income imports all the principles explored in Part I. Thus working expenses which relate to property will be deductible if the property is held for the derivation of income in the carrying on of a business, or is held for the derivation of income from property. A conclusion that gains are not income because there is no business from which the gains arise (Proposition 14 in Chapter 2) will carry the consequence that expenses which relate to those gains are not deductible. The hobby farmer is not entitled to deductions under s. 51(1), because gains from his activity are not income. A conclusion that the letting of property to another at a modest rental, moved by a charitable motive or family generosity, is not a letting which can give rise to a gain derived from property, will carry the consequence that expenses which relate to the
property let are not deductible. The matter is more fully considered in [6.161]–[6.167] below. It is enough to note at this point that the question whether any rent arising from the letting is income, or would be income if derived, is primary. The answer may be that it is not, if the purpose of the letting was not to obtain a commercial return, just as gains from an activity which could amount to a business will not be income if the purpose of the activity is not to derive an overall profit from that activity. In the same way, a conclusion that the lending of money to another at no interest or at a modest rate of interest, moved by a charitable motive or family generosity, is not a lending which can give rise to a gain derived from property, will carry the consequence that an interest expense which relates to the money lent is not deductible.

5.51 While logically distinct, the issues of relevance and working character tend to be run together in a decision on the deductibility of an expense. Where however the focus of the discussion is on the private or domestic contradistinction, the issue is likely to be simply one of relevance. The expenses of travel to and from a place of work could hardly be seen as other than working. The issue, as in the cases of the expenses of food and clothing, is whether the expenses are sufficiently related to the process of income derivation. The resolution of that issue cannot always depend on precedent and logic. At the margin of any legal principle a policy judgment must be made, though most often that policy judgment will be obscured by judicial observations on the “difficulties” experienced in coming to a decision. A conclusion that an expense is private or domestic may be dictated by the need to preserve the base of the income tax against a submission which can be made in regard to almost any expense imaginable, that it has some relevance to the derivation of income. The minority judgments in Forsyth (1981) 148 C.L.R. 203 and Handley (1981) 148 C.L.R. 182 are impeccable in their logic. There is no question that home-study expenses have some relevance to income derivation. The logic of the majority judgment is not impeccable. The notion of “essential character” of expense does not clarify. It serves only to obscure the policy decision that to allow deductions of all home-study expenses would be to set the point where expenses are sufficiently connected to be relevant so far from the process of derivation of income, that the base of the income tax is in danger of becoming limited to income saved. These matters are considered further in [8.10]–[8.37] below.

5.52 Where questions of relevance and working character are run together, it is generally because there can be no question of relevance, and the issue is simply whether the expense is a working as distinct from a capital expense. John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30, considered in
[7.61]–[7.62] and [7.70] below affords an illustration. **5.53** Sometimes, however, relevance and working character are virtually indistinguishable. Some of the cases involving events by which a taxpayer is deprived of his assets, considered in [6.52]–[6.77] below, might equally be explained on the score of relevance as on the score of working character.
Chapter 6: Relevant and Working Expenses

6.1 In this chapter and in the chapters that follow, the discussion is arranged under headings that distinguish (i) expenses which are relevant and working from (ii) expenses which are relevant but capital, and from (iii) expenses which are irrelevant. Only expenses which are properly described by the first heading may be deductible under s. 51(1). Expenses described by the second may be deductible under other sections of the Act, more especially the depreciation provisions in s. 54ff. Some expenses described by the third heading were deductible under specific provisions which have now been replaced by provisions allowing “concessional rebates” of tax: Subdiv. A of Div. 17 of Pt III. Specific provisions more recently introduced allow deductions which relate to contributions to superannuation funds (Subdiv. AB of Div. 3 of Pt III) and to costs of home insulation (Subdiv. E of Div. 3 of Pt III). They are exceptions to a general denial of deductibility of expenses covered by the third heading.

The Purpose of an Expense: Objective and Subjective Approaches

6.2 A good deal of the discussion in the cases on the issues of relevance and working quality has been concerned with identifying the “purpose” of the expense. There is a question of what might be meant by purpose in this regard. It should at the same time be noted that identifying purpose cannot always be a useful exercise. Where a loss is suffered in some transaction and the loss is the item of possible deduction, it is hardly sensible to be concerned with the purpose of the loss. It may be appropriate to consider the purpose of the transaction out of which the loss arose. This purpose may be relevant, on principles examined in Chapter 2 above to a conclusion that the transaction is one which might have given rise to a profit that was income, and for this reason a loss which in fact results is deductible. Where the loss is suffered as a result of the action of some person who has deprived the taxpayer of his property, there is even less sense in seeking to identify purpose.

6.3 In most circumstances, however, identifying the purpose of an expense is thought to be helpful in characterising an expense as relevant and working, though the word “purpose” does not appear in s. 51(1) as bearing on deductibility. There is a reference to purpose in the second limb but only in the context of “purpose of producing assessable income” in the carrying on of a business. Where purpose is sought to be identified, there is
a question of what may be meant by purpose. A variety of judicial opinions appears in the cases. The view of Dixon J. and Latham C.J. in two earlier cases will illustrate. In *Amalgamated Zinc (De Bavay's) Ltd* (1935) 54 C.L.R. 295 at 309 Dixon J. said that s. 51 looked “rather to the scope of operations or activities and the relevance thereto of the expenditure than to the purpose in itself”. The objective test thus suggested, if applied without qualifications, would require that an inference be drawn as to purpose from all the circumstances but would exclude any direct evidence, by admission or otherwise, of the purpose in fact of the taxpayer. It would be a matter of what the reasonable man would impute to the taxpayer as his purpose if the reasonable man were to look only at the circumstances and were denied any direct evidence of the taxpayer’s purpose. This method of determining purpose is closely parallel with the method of determining purpose in the interpretation of s. 260 and may well be the method of determining purpose that will be followed under the new Pt IVA that has taken the place of s. 260. However, in the passage quoted from *De Bavay’s* Dixon J. sought to leave some scope for the subjective purpose. In *Finn* (1961) 106 C.L.R. 60, Dixon C.J. showed himself again unwilling to exclude entirely any relevance of subjective purpose. In discussing the circumstances which were relevant in judging the purpose of the expenditure he referred to the motivation of the taxpayer, though he prefaced his words by the phrase “so far as motive or purpose is material”. On the other hand in *Robert G. Nall Ltd* (1937) 57 C.L.R. 695 which, it should be noted, precedes *Finn*, Dixon J. seemed to exclude subjective purpose entirely. Referring to purpose as “an elusive and indefinite criterion”, he asserted that purpose is “an attribute of the transaction rather than a state of mind” and concluded that “the circumstances of the transaction must give it the [required] complexion” (at 711–12).

**6.4** In *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290 and *Nall*, Latham C.J., in choosing words to explain the application of s. 51, was more ready to give significance to subjective motivation. Thus in *Nevill* at 301 he referred to determining the purpose of the taxpayer “in relation to the object which the person making the expenditure has in view”. In *Nall* he preferred some combination of the subjective and the objective. Thus he said at (705–6) that the purpose the taxpayer had in mind was not always the test: s. 51 was concerned with the “relation between the expenditure . . . and the income produced in the course of the income-earning enterprise” and this relation he thought “contemplates a test which may be applied objectively”. However he thought the application “may be affected . . . by consideration of . . . states of mind”.

**6.5** The reference in the judgment of Dixon C.J. in *Finn* to both “purpose”
and “motive” gives warning of the complexities into which too great a concern with subjective purpose may lead. The discussion in [3.19]ff. above of the distinction between purpose and motive drawn in relation to s. 26(a) (now s. 25A(1)) illustrates those complexities.

6.6 A review of more recent judicial statements on the issue of subjective or objective purpose is made in the judgments in the Federal Court in Magna Alloys & Research Pty Ltd (1980) 80 A.T.C. 4542. Since De Bavay's, Nevill, Nall and Finn the interpretation of s. 51(1) has experienced a development which has its beginning in Cecil Bros Pty Ltd (1964) 111 C.L.R. 430 and its culmination in the decision of the Privy Council in the New Zealand appeal in Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2) (1976) 76 A.T.C. 6001. That development may be seen as adopting a subjective approach, and then limiting the evidence that is relevant to a conclusion as to the taxpayer's purpose. The insistence that it is not for the Commissioner or court to tell the taxpayer how to run his business adopts a subjective approach. A taxpayer whose subjective purpose makes his expense wholly relevant to the derivation of income cannot be told that an objective inference from the circumstances—in particular the excessive amount of the expense—is that the outgoing was at least in part not relevant and, to this extent, must be denied deduction. The culmination of the development is in Europa Oil (No. 2), which may be seen as adopting a rule of evidence that where an outgoing is made in pursuance of a contractual obligation, no evidence of the purpose of that outgoing may be considered except the terms of the contract. Cecil and Europa Oil (No. 2) have already been the subject of some comment in Chapter 4 at [4.240]–[4.242] above and they are again considered below in [9.17]–[9.26]. The Cecil-Europa Oil (No. 2) development has suffered some, though a very little, check in South Australian Battery Makers Pty Ltd (1978) 140 C.L.R. 645. The judges in Magna Alloys had none the less to accommodate the development, and did this by putting payments under contractual obligations to one side, treating the payments made by the company of legal expenses incurred by employees in the defence of criminal proceedings, as voluntary payments.

6.7 Within the field of voluntary payments, the judgments in Magna Alloys catalogue judicial statements on the subjective or objective question and indeed attempt to reconcile them. Brennan J. attempted a reconciliation thus:

“Given a sufficient identification of what the expenditure is for and the character and scope of the taxpayer's income-earning undertaking or business, the question whether expenditure is incurred for the purpose of carrying on a business or for the purpose of gaining or producing assessable income does not depend upon the
Deane and Fisher JJ. rejected the view of Sheppard J. at first instance that the purpose to be identified was the dominant subjective purpose of the taxpayer:

“The fact that the needs of some directors and agents provided the occasion of an outgoing and that the resulting benefit to directors or agents constituted the dominant motive of a taxpayer for incurring it does not, of itself, preclude the outgoing from being necessarily incurred in carrying on the taxpayer's business for the purpose of s. 51(1)” (at 4560).

They then offered a reconciliation in these terms:

“Whether a voluntary outgoing was so incurred depends upon the answer to the composite question . . . whether the outgoing was reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends of that business and, if so, whether those responsible for carrying on the business so saw it” (at 4560–4561).

6.8 The reconciliation by Brennan J. might appear to come down on the side of objective purpose, though the preambles make his choice rather hollow—indeed the first of the preambles seems to contradict his choice. The reconciliation by Deane and Fisher JJ. in the “composite question” might be thought to require that purpose must be identified both objectively and subjectively, and the expense must be shown to be relevant in terms of both identifications.

6.9 In what follows in this chapter the assumption is made that s. 51(1), so far as it looks to purpose at all, looks to the objective purpose served by an expense. Some assumption must be made if discussion is to proceed. The assumption challenges the Cecil-Europa Oil (No. 2) development. Cecil may be explained as a decision of the Full High Court on s. 260 only. It was decided in the Full Court on the assumption that the decision of Owen J. at first instance on s. 51(1) was correct, but there was no endorsement of the decision of Owen J. The Commissioner had not appealed against the decision on s. 51(1). Europa Oil (No. 2) is not a decision in the Australian hierarchy of courts. It may have received some approval in South Australian Battery Makers, but the approval goes to the rule that would exclude evidence of facts other than the contract. South Australian Battery Makers does not approve the choice of subjective purpose which Europa Oil (No. 2) might be thought to have made. There is a reference to the judgment of Gibbs A.C.J. (at 653) to a statement given in affidavit evidence that the annual rent was “a reasonable commercial amount”. Gibbs A.C.J. added this observation: “and [if it matters] that statement was
not contradicted in evidence.” Given the limitation of the evidence from which an inference may be drawn—the limitation which follows from the approval of *Europa Oil (No. 2)—an objective inference of a purpose other than the purpose of obtaining the use of premises as a lessee could not have been drawn.

6.10 Where purpose bears on the relevance of an expense, the administration of the law will be assisted by an objective approach. On some matters of the income tax an inquiry which goes to the taxpayer's mind is unavoidable. Thus, as Brennan J. observed in *Magna Alloys*, the question whether the taxpayer's activities amount to a business requires some inquiry of this kind. But to require the taxpayer to establish his subjective purpose, if he is to discharge the onus of proof he carries under s. 190(b), when asserting a deduction under s. 51(1), will make the law unmanageable. *Magna Alloys* demonstrates the subtleties which would be attracted—subtleties which involve distinctions between motive and intention, and involve questions as to which of these is the purpose that must be identified, and subtleties which involve a distinction between dominant and subordinate purposes where more than one is identified, and the significance of the fact that the purposes are supportive or contradictory. These subtleties are attracted in the application of s. 25A(1) (formerly s. 26(a)) which has been held to be concerned with subjective purpose. Experience with them in that context may suggest that they should not be given further room.

6.11 It is true that an objective approach does not necessarily exclude these subtleties. The inference from evidence other than direct evidence of a taxpayer's state of mind, could conceivably yield motive and intention and dominant and subordinate purposes, but in fact an inference of one purpose as the purpose that the observer would conclude the taxpayer had is as much as is likely to be drawn. An objective approach will minimise the concern with the state of mind of the taxpayer. Indeed the objective approach is sometimes expressed to be concerned with the purpose of the “transaction itself” (cf. Lord Denning in *Newton* (1958) 98 C.L.R. 1). The notion of purpose as a state of mind is then so deemphasised that it might be thought to have disappeared, and the inquiry is seen as directed to the “function” of the transaction.

6.12 One consequence of an objective approach is to qualify in some degree the validity of an observation in *Ronpibon Tin N.L.* (1949) 78 C.L.R. 47 at 60 which has come to command ritual mention in cases involving s. 51(1): “It is not for the court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent: see per Ferguson J. in *Tooheys Ltd v. C. of T.* (N.S.W.)
(1922) 22 S.R. (N.S.W.) 432 at 440; per Williams J. in *Tweddle v. F.C.T.* (1942) 7 A.T.D. 186 at 190.” Yet, where a taxpayer has spent an amount in obtaining the supply of goods or services from another with whom he does not deal at arm's length, and that amount is greater than he would have spent in obtaining the same supply in an arm's length transaction, an objective inference may fairly be drawn as to his purpose which will require a conclusion that the expense is in some part not relevant to derivation of income. That objective inference will prevail against any direct evidence of the taxpayer's state of mind which may support his claim that his purpose was solely to obtain the supply of goods or services.

**6.13** Ritual mention of the observation in *Ronpibon* was made by Owen J. at first instance in *Cecil* (1964) 111 C.L.R. 430 at 434. At the same time any objective inference from the facts that the taxpayer's purpose was in part to shift profit, and not to obtain stock in trade, was rejected. The rejection of the objective inference might be thought to have left the subjective purpose—also in part a purpose to shift profit—to prevail. But it did not. Subjective and objective purposes were both displaced by a principle that the purpose by reference to which an expense is to be characterised where the expense satisfies a contractual obligation, must be found from and only from the terms of the contract. Other evidence of the purpose of the taxpayer must be rejected.

**6.14** It was acknowledged by Owen J. that one of the taxpayer's purposes was not to obtain stock but to shift profit. It is a strange quirk of legal history that an entirely sensible observation by the High Court, made in the context of arm's length transactions where there could be no suggestion of a purpose determined subjectively or objectively other than a purpose to obtain services, should have come to be claimed as the basis at once for the suppressing of an objective approach to the determination of purpose, and for a limiting rule of evidence that will nullify both subjective and objective approaches.

**6.15** The significance given to the legal form of a transaction by *Cecil* and *Europa Oil (No. 2)* has been the subject of comment in [4.233]–[4.242] above. And it is the subject of further comment in [9.17]–[9.26] below. The significance thus given to form is at odds with decisions of the High Court, for example in *Dickenson* (1958) 98 C.L.R. 460 in relation to the quality of an item as income, and it is at odds with decisions of the High Court in other cases concerned with s. 51(1). Neither the High Court nor the Privy Council in *B.P. Australia Ltd* (1965) 112 C.L.R. 386 sought to identify purpose solely by reference to the agreements under which the payments were made. It is true that *B.P. Australia Ltd* was not concerned with the identification of purpose for its bearing on relevance. The issue
was whether the expenses were working as distinct from capital expenses. This was the issue also in *Hallstroms* (1946) 72 C.L.R. 634 where Dixon J. expressed a view which is opposed to the significance given to form by *Cecil* and *Europa Oil (No. 2)*. But there would not appear to be any reason why form should prevail where the issue is relevance, but not where the issue is working character.

6.16 A consequence of *Cecil* and *Europa Oil (No. 2)* might appear to be the defeat of the taxpayer where the purpose identified by reference only to the contract does not establish relevance. In *Cecil* and *Europa Oil (No. 2)* the contract was for the acquisition of trading stock, and a purpose identified only by the terms of the contract established relevance. At least it was assumed that this was so, though as explained in [4.240] above and [9.17] below, the court simply assumed a rule as to relevance which may not always be a sound expression of the principles in s. 51(1)—a rule that an expense for the purpose of acquiring trading stock is a relevant expense. If *Magna Alloys & Research Pty Ltd* (1980) 80 A.T.C. 4542 had been seen as a case in which the legal form must prevail, the taxpayer might have been unable to obtain a deduction because the form of a contract to pay legal fees had closed off an inquiry which might have established a purpose that would have given the character of relevance to the expense.

### The Significance of the Fact that an Expense is Unusual

6.17 Statements by Dixon J. in *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290 and by the court in *Charles Moore & Co. (W.A.) Pty Ltd* (1956) 95 C.L.R. 344 indicate that an expense may be deductible notwithstanding that it is unusual. In *Nevill*, Dixon J. said (at 306): “In the present case the payment of a lump sum to secure the retirement of a high executive officer may have been unusual. But it was made for the purpose of organising the staff and as part of the necessary expenses of conducting the business. It was not made for the purpose of acquiring any new plant or for any permanent improvement in the material or immaterial assets of the concern. The purpose was transient, and, although not in itself recurrent, it was connected with the ever recurring question of personnel.” And in *Moore* (at 351) there is a similar observation which follows a quotation from the judgment of Rich J. in *Ash* (1938) 61 C.L.R. 263 at 277: “There is no difficulty in understanding the view that involuntary outgoings and unforeseen or unavoidable losses should be allowed as deductions, when they represent that kind of casualty, mischance or misfortune which is a natural or recognised incident of a particular trade or business the profits of which are in question. These are characteristic incidents of the systematic
exercise of a trade or the pursuit of a vocation.” The observation in Moore is: “Even if armed robbery of employees carrying money through the streets had become an anachronism which we no longer knew these words would apply. For it would remain a risk to which of its very nature the procedure gives rise. But unfortunately it is still a familiar and recognised hazard and there could be little doubt that if it had been insured against the premium would have formed an allowable deduction. Phrases like the foregoing or the phrase “incidental and relevant” when used in relation to the allowability of losses as deductions do not refer to the frequency, expectedness or likelihood of their occurrence or the antecedent risk of their being incurred, but to their nature or character. What matters is their connection with the operations which more directly gain or produce the assessable income.”

6.18 The statements need to be considered in context. In each case the statement was made in relation to the relevance of the expense, not its quality as a working expense to be distinguished from a capital expense. It is clear from the words quoted from Nevill that the fact that an expense is unusual may suggest that it goes to the structure of the activity by which income is derived. The court was not prepared to treat the securing of the retirement of a high executive officer as effecting a change in structure, but the possibility is left open that a contract with an employee may be of such importance—albeit as a burden on efficiency—that an expense to secure a release from the contract is a capital expense. In Foley Brothers Pty Ltd (1965) 13 A.T.D. 562 a payment to secure a release from a contract which stood in the way of a restructuring of the company's activities so as to reduce the scope of its operations was held not to be a working expense. In Charles Moore the robbery was of cash held for purposes of the business operations. It will be submitted later in this chapter that cash so held will always be a revenue asset so that the possibility of a loss arising from the robbery being a capital loss was not fairly raised. If unusual circumstances in which cash is held can make its holding a matter of structure, any general proposition that it is irrelevant that an expense is unusual requires qualification.

6.19 In Nevill there was no question of closing down the business operations managed by the high executive. If the company had been closing down that part of its operations the payment might well have been held not working, being an expense in effecting a change in structure.

6.20 Where the issue is simply one of relevance, it is in general enough that the purpose of an outgoing which is not itself recurrent, connects it “with the ever recurring question of personnel” in circumstances such as in Nevill or, in the circumstances of Charles Moore, it is enough that the loss
represents “that kind of casualty mischance or misfortune which is a natural or recognised incident of a particular trade or business the profits of which are in question” (Ash (1938) 61 C.L.R. 263 at 277 per Rich J., quoted in Charles Moore (1956) 95 C.L.R. 344 at 350-1). None the less an assertion of the irreleva nce of the unusual nature of an expense may be unwarranted. There must be circumstances where an expense apparently connected with “the ever-recurring question of personnel” is denied relevance because of its purpose. If the securing of the retirement of a high executive officer is sought because there has been a successful take-over of the employer company and the new controllers seek to replace the existing executives, it is arguable that the purpose of the payment to secure retirement is not such as to make it relevant to the derivation of income. The purpose is to enable the exercise of power by the controllers. Whether the argument will succeed will, to a degree, depend on the approach—subjective or objective—taken to the determination of purpose, a matter considered under the last heading. If an objective approach is taken—the submission has been made that it should be taken—the purpose established may be no different from the purpose found in Nevill. An objective approach in Magna Alloys & Research Pty Ltd (1980) 80 A.T.C. 4542 to the question of the purpose of the payment of the costs of defence of directors of the taxpayer company in criminal proceedings, supported an identification of purpose to serve the taxpayer's business interests, though a subjective approach might have required a conclusion that the purpose was to serve the personal interests of the directors.

6.21 Nevill and Charles Moore support a proposition that an expense is relevant to the derivation of income if it is one of a class of expenses that are a “natural or recognised incident” of the activity, or holding of property, whence income is derived. Where the purpose of the expense bears on its relevance, the fact that the subjective purpose makes the expense an unusual one will not deny it entry to the class, provided an objective inference of purpose would allow it to enter. Where the purpose of an expense has no bearing, as in Charles Moore, a broad view is to be taken of what is a natural or recognised incident, and the wider the description of the class of expenses so regarded the more is the prospect that an unusual expense will enter that class.

The Relevance of the Character of a Receipt by the Payee

6.22 In Nevill the Commissioner contended that the payment to the managing director was a capital, not a working expense of the company. Dixon J. observed: “Some of the reasons given in support of the argument
treated the question whether the payment of the retiring allowance by the company should be considered as part of its capital expenditure as interdependent with the question whether its receipt by the managing director should be considered part of his assessable income or as an addition to his capital. In my opinion there is no necessary connection between the two questions and, indeed, an attempt to obtain guidance in the solution of one by considering the other is not without danger” (at 306).

6.23 These observations were made in relation to the question whether the company's expense was a working expense or a capital expense. They are at least equally valid when the question is whether the company's expense is relevant or irrelevant to the derivation of income. An outgoing must take its character from the circumstances in which it is incurred by the taxpayer claiming the deduction. The income character of the receipt of that outgoing in the hands of the receiver is not in itself relevant to deductibility by the payer. Of course, the Commissioner has an interest in having the diminution of tax which a deduction allowed will involve, matched by an increase in tax which a derivation of income by another will involve. But there is no principle that a deduction by one taxpayer must be matched by a derivation of income by another in the transaction which gave rise to the deduction.

6.24 This is not to say that the circumstances which give deductibility to an outgoing have no bearing on the derivation of income by the person who receives the amount of the outgoing. And the circumstances of derivation of income in the receipt of the amount of an outgoing by another may have some bearing on deductibility of the outgoing. The circumstances of the payment or receipt by one person, are some part of the circumstances of the receipt or payment by the other. In Chapter 2, [2.206]–[2.207] above, attention was directed to *Egerton-Warburton, Colonial Mutual Life* and *Cliffs International*. In *Egerton-Warburton* (1934) 51 C.L.R. 568 it was said that payments which were income as an annuity in the hands of the taxpayer were deductible by the taxpayer's sons, who had acquired property from their father under the transaction which required payment of the annuity. It might be suggested that the quality of income in the hands of the father could be explained on the ground that there was a sharing by the father in the income from the property acquired by the sons, and that this directed that the payments by the sons were deductible. Such a suggestion is not, however, supported by *Colonial Mutual Life Assurance Society Ltd* (1953) 89 C.L.R. 428 where outgoings were held not deductible, though they might have been seen as having been made in the sharing of income with the person receiving them. In *Just* (1949) 23 A.L.J. 47 the person who had received in the facts of *Colonial Mutual Life* had been held to have
derived income as periodical receipts. The conclusion, it seems, is that the circumstances of sharing may give an income quality to periodical receipts by the person receiving, but will not give the character of deductibility to payments made in the course of sharing. The matter is further considered in [6.301]–[6.307] below. But it would be an unacceptable proposition that the facts by which deductibility by a payer is judged are irrelevant in determining income character in the hands of the receiver, or that the facts by which income character in the hands of the receiver is judged are irrelevant in determining deductibility by the payer. Thus a purpose of a payer to reward another for services when making a voluntary payment to that other must have a bearing on the character of the receipt in the hands of the payee. At the same time it must have a bearing on deductibility by the payer. The matter is considered again in [6.175] below.

6.25 In *Cliffs International Inc.* (1979) 142 C.L.R. 140 outgoings were held deductible. There is some support in the judgment of Barwick C.J. for a view that an income quality in the hands of those receiving the amounts of the outgoings, Howmet Corporation and Mt Enid Pty Ltd, was relevant to deductibility by Cliffs International. He expressed an opinion that the receipts would have an income quality. The relevance could be explained in terms of a sharing of the income which Cliffs International derived from the exploitation of the property it had acquired, ultimately from Howmet and Mt Enid. There is, however, another explanation of *Cliffs International* which would relate deductibility of payments and income quality of receipts in a different way. The judgments of the majority adopt a view that the payments to Howmet and Mt Enid were akin to payments of royalties. They were payments for the use of property, and this, one would think, is reason for saying that those payments were receipts for the use of property in the hands of the receivers. They were, it is true, payments for use and receipts for use only in a broad sense of each notion. The mining rights exploited by Cliffs were now owned by Cliffs. Cliffs had acquired from Howmet and Mt Enid all the shares in a company which owned those rights, and had then acquired the rights by liquidation of that company. None the less, if legal concepts in relation to ownership of the rights are ignored, and the matter is seen in its commercial context, the payments required to be made over the whole life of the rights, were made for the use of property and were received for the use of property.

6.26 *Cliffs International* is the subject of further comment later in this chapter. For present purposes it is enough to drawn attention to the case as an illustration of how the characterisation of an outgoing or receipt may be relevant to the characterisation of a corresponding receipt or outgoing. The relevance in this kind of case does not however require any conclusion on
income or deductibility. In Chapter 2, several cases, including Hayes (1956) 96 C.L.R. 47 and Scott (1966) 117 C.L.R. 514, concerned with the characterisation of a receipt, paid voluntarily, as a reward for services, were considered. One factor that might justify such a characterisation is that the payer's purpose (“motive” in the view of Fullagar J. in Hayes) was to reward the taxpayer for services rendered. The payer's purpose does not however require such a characterisation. And a conclusion that the receiver derives income as a reward for services does not require a conclusion that the payer is entitled to a deduction for a payment that is a reward for services.

The Characterisation of Fines, Penalties and Expenses of Defence

6.27 An amendment to s. 51 of the Assessment Act in 1984, adding s. 51 (4), has dealt expressly with the deductibility of fines and penalties, and may bear on the deductibility of the expenses of defence. Section 51(4) provides:

“A deduction is not allowable under sub-section (1) in respect of—

(a) an amount, however described, payable, or expressed to be payable, by way of penalty under a law of the Commonwealth, a State, a Territory or a foreign country; or
(b) an amount ordered by a court, upon the conviction of a person for an offence against a law of the Commonwealth, a State, a Territory or a foreign country, to be paid by the person.”

6.28 The provision clearly extends beyond fines in what may be technically criminal proceedings. But there are questions to be resolved as to how far it extends. Thus, s. 82 of the Trade Practices Act provides for an action for damages at the instance of a person who suffers loss or damage by reason of the contravention of the resale price maintenance provisions of the Act. It may be asked whether damages awarded under such a provision would be denied deduction under s. 51(4). It would be argued that the damages do not amount to a penalty where there is no provision for an award that would be greater than the damage suffered. It would follow that damages awarded under the general law for breach of a statutory duty do not involve a penalty though the possibility of an award of exemplary damages may cast some doubt on that conclusion. An actual award of exemplary damages in an action under the general law not involving a breach of statutory duty is presumably not a penalty within s. 51(4)(a). It would be argued that it is not an award under “a law”.
6.29 Section 51(4), presumably, will extend to a payment made by a person other than the person on whom the penalty or fine is imposed. The payment might be made directly to the public authority by the employer of the person who has committed the breach, or by the principal of a third party contractor as in *Magna Alloys* (1980) 80 A.T.C. 4542. Deduction would be denied, as a payment “in respect of” the amount of the penalty. It is doubtful, however, whether a payment made by way of a reimbursement to an employee or a contractor of a penalty or fine imposed on and paid by the employee or contractor is covered by s. 51(4). The words “in respect of” are words of wide meaning but they may not carry the denial of deductibility so far.

6.30 Section 51(4) is concerned, it seems, only with payments of the amount of the fine or penalty. It would not deny the deduction of expenses of defending proceedings brought against the taxpayer, or his employee or third party contractor. The words “in respect of an amount” would not extend the operation of the provision to cover expenses that are directed to ensuring that no amount ever becomes payable. *Magna Alloys* had held expenses of defence to be deductible, and a change by s. 51(4) in the law thus established should require some express provision. Section 51(4), it would be argued, is no more than declaratory of the law established by the Federal Court in *Madad Pty Ltd* (1984) 84 A.T.C. 4739.

6.31 Section 51(4) is a culmination of the development of the law in the interpretation of s. 51(1). That law is reviewed in what follows not only for the assistance that it may give in the interpretation of s. 51(4), but also to show the state of the law in those areas, more particularly the payment of expenses of defence of proceedings, to which s. 51(4) does not extend.

6.32 A number of situations must be distinguished in regard to fines, penalties and expenses of defence. The treatment of the payment of a fine or penalty may be different from the treatment of the payment of expenses of defence. And it may be necessary to treat differently a payment by the person on whom a fine or penalty is or might be imposed from a payment by another person. In *Magna Alloys & Research Pty Ltd* (1980) 80 A.T.C. 4542, referred to above on the question of the nature of the purpose that is relevant to deductibility, there are references to dicta in Australian cases relying on some United Kingdom cases, which suggest that there is an overriding rule which will exclude from deductibility a fine or penalty paid by the person on whom the fine or penalty has been imposed. The Australian cases are *Herald & Weekly Times Ltd* (1932) 48 C.L.R. 113 and *Snowden & Willson Pty Ltd* (1958) 99 C.L.R. 431. The United Kingdom cases are *I.R.C. v. Warnes & Co. Ltd* [1919] 2 K.B. 444, and *I.R.C. v. von Glehn & Co. Ltd* [1920] 2 K.B. 553. The rule would exclude the payment...
of the fine or penalty from deductibility, whatever the relevance of the outgoing and however much it fits the notion of a working expense. In the joint judgment of Gavan Duffy C.J. and Dixon J. in *Herald & Weekly Times* (1932) 48 C.L.R. 113 at 120 it is said: “The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a person deterrent . . . ” In *Magna Alloys* Deane and Fisher JJ. questioned the reason that “its nature severs it from the expenses of trading” observing that:

“It is somewhat difficult to understand how it can be maintained, as an unqualified proposition, that the nature of a penalty severs it from the expenses of trading. Recurrent penalties for parking infringements incurred by a delivery man and per diem penalties for unlawfully using premises for business or commercial purposes in contravention of zoning requirements are not, for example, logically severed from the expenses of trading. The same can be said of fines imposed for actually engaging in some unlawful activities, such as illegal bookmaking or soliciting, for the purpose of earning assessable income” ((1980) 80 A.T.C. 4542 at 4563).

Deane and Fisher JJ. considered that if deductibility is denied it should be on the basis of an overriding consideration of public policy.

6.33 In *Madad Pty Ltd* (1984) 84 A.T.C. 4739, the Federal Court referred to *Magna Alloys* and the dicta in *Herald & Weekly Times* and *Snowden & Willson*, and to the United Kingdom authorities, and concluded that the approach in the dicta of the High Court should be followed, whether those dicta are to be explained in terms of the principle of relevance or public policy. In the result, the court denied deduction of a penalty imposed on the taxpayer for breach of the resale price maintenance provisions of the *Trade Practices Act*. The penalty, it was admitted, was not imposed in a criminal proceeding, but the court considered that the rule to be found in the dicta applied to such a penalty. The court said (at 4744): “It has been accepted that the taxpayer was not aware that it was infringing the *Trade Practices Act*, or any other legislation. However, what it did was contrary to one of the provisions of an Act designed to regulate commerce in the public interest. Although the contravention is not to be treated as a criminal offence, there are nevertheless heavy pecuniary sanctions for its observance.” The reference to “heavy pecuniary sanctions” may suggest that the court was adopting a rule that would not apply to minor penalties, such as parking infringement penalties. But any such inference is dispelled by the way the court dealt with the decision of Ormiston J. in *Mayne Nickless Ltd* (1984) 84 A.T.C. 4458. Ormiston J. had held that fines and penalties paid by the taxpayer and imposed on the taxpayer, or on one of his employees or third party contractors, were not deductible. The majority
of the offences in respect of which the fines and penalties were paid were for parking infringements, and the overloading of vehicles. The rest were for speeding, defective tyres, and a number of other offences. The judgment of Ormiston J. is referred to without indication of any disapproval. The Federal Court would, it seems, support a rule that does not distinguish offences either in terms of any moral judgment of them, or in terms of the level of penalty that may be imposed. The reference to Mayne Nickless may also be taken to reflect a view of the Federal Court that the rule denying deduction should extend to payments by the taxpayer of penalties imposed on himself or on others. Section 51(4) may thus be seen as statutory confirmation of the judgment of the Federal Court.

6.34 Whatever the scope of the rule recognised in Madad in regard to fines or penalties imposed on the taxpayer himself or his employee or third party contractor, it would not necessarily extend to exclude deductibility of the expenses incurred by the taxpayer in defending himself or one of those other persons. Brennan J. in Magna Alloys discounted the denial of the deduction of such costs in the United Kingdom cases by referring to the different words of the United Kingdom legislation governing deductibility. If expenses of defence are to be given the same treatment as a fine that might be imposed, they should be given this treatment only where they are expenses of an unsuccessful defence. If the principle excluding deductibility is put on the ground of public policy, the principle could hardly extend to the expenses of a successful defence, at least if the outcome is a simple acquittal. There is nothing in the judgment of the Federal Court in Madad that might reflect on the decision in Magna Alloys that expenses of defence of criminal proceedings, even though unsuccessful, may be deductible. Section 51(4) does not reverse that decision.

6.35 The operation of s. 51(1), where deductibility is not denied by s. 51 (4), depends on the outgoing being both relevant and working. It will be apparent from the passage quoted above in [6.32] from the judgment of Deane and Fisher JJ. in Magna Alloys that outgoings in meeting the expenses of defence may well have a sufficient connection with income derivation to make them relevant. The illustrations in the quotation are obviously “natural or recognised incident[s]”. The expenses of defence in circumstances otherwise within Magna Alloys, if the proprietor of the business is himself the offender, may not be so obviously natural or recognised incidents. There is a tendency to judge what is natural, not by what commonly happens, but rather by what ought to happen. Relevance, it is none the less submitted, is a matter of connection between the derivation of income and committing the offence: it is not a matter of how income
derivation should be carried on.

6.36 If the moral enormity of the offence is not enough to deny the relevance of the expenses, it may, however, deny their character as working expenses. A conviction may so affect the goodwill of business that the expenses of defence are not working but capital expenses. They are expenses of defending the income producing structure in a situation of peril and on this ground capital. The effect on goodwill aside, conviction for an offence may have the consequence that the taxpayer will thereafter be forbidden to carry on the activity whence income is derived, or be in jail and unable to carry it on: a solicitor's conviction for fraud may be an illustration. In these circumstances, the expenses of defence may be non-working and capital.

6.37 Whether or not the taxpayer is convicted, any bearing of moral enormity on the issue of relevance should be excluded. On the issue of relevance the question is simply whether the carrying on of the business brought with it allegations of offences of this kind (adapting the words of Dixon C.J. in *Snowden & Willson* (1958) 99 C.L.R. 431 at 436). On the issue of working or capital, moral enormity, for reasons already explained, may make the expenses a matter of defending structure in a situation of peril and thus capital.

6.38 Where payment of the expenses of defence are made, not by the person who has committed the offence, but by a third party, the analysis may be different. The typical case will involve a company employer meeting the expenses of an employee, as in *Magna Alloys*. There would not appear to be any basis in public policy for denying a deduction to the company, unless the company has induced the criminal activity by its employee. Deane and Fisher JJ. in *Magna Alloys* said:

“... there are sound arguments to support the view that, in the absence of any question of inducement to criminal activity, an outgoing which is designed to achieve the result that a citizen charged with a criminal offence has proper and adequate legal representation, is positively in the public interest. Plainly, such an outgoing cannot be properly regarded as being contrary to contemporary notions of public policy” ((1980) 80 A.T.C. 4542 at 4564).

6.39 Relevance, where the expenses are met by the employer, will be established by showing that the committing of the offence by the employee, or the allegation of it, is a natural or recognised incident of the income derivation. The objective inference is that the employer's purpose is to ensure that the employee does not have to meet expenses which may fairly be said to have arisen in the carrying out of his duty as an employee. Good relations with employees will be served. The employer's reputation
for dealing fairly with his employees is enhanced. Indeed, relevance may 
be established where the offence is not a natural or recognised incident, if 
an objective inference is to be drawn that the employer was concerned to 
preserve good relations with employees. The task of establishing relevance, 
ought not to be significantly more difficult if the employer has paid the 
expenses of defence of a third party contractor.

6.40 A relevant outgoing in meeting the expenses of the defence of an 
employee or a third party contractor may be capital and thus not working. 
A conviction of an employee, if not of a contractor, may have implications 
for the employer's business which make the expenses a matter of defence 
of structure in a situation of peril. A suggestion that the expenses were 
capital in Magna Alloys was rejected by the Federal Court. Where, 
however, a conviction may lead to imprisonment of a company's employee 
who is its sole shareholder, a director, and senior executive, it will be 
difficult to avoid a conclusion that the expenses are capital. If the employee 
has no proprietary interest in the company, a conclusion that the expenses 
are capital is the less likely. But, in theory at least, the employee may be a 
“key-man” and the continued availability of his services an aspect of the 
structure of the company's business.

6.41 If charges are made against the employer as well as the employee or 
contractor, the expenses of defence are paid for two purposes and 
deductibility of the payment as it relates to each purpose will be 
determined by the application of the analyses explored above. It is unlikely 
that a different conclusion on deductibility may result in regard to each 
purpose. If it does, problems of apportionment explored in Chapter 9 below 
will be raised.

6.42 Some indications were given above of the significance of facts that 
the employee is a proprietor, a director and senior executive of a company 
employer, where the question is whether the outgoing is working or capital. 
The fact that the employee is a proprietor, director and senior executive 
may bear on the threshold question of relevance. An objective inference 
may in some circumstances be drawn that the purpose of the company in 
meeting the expenses was not to ensure that the employee was indemnified 
against expenses which might fairly be said to have been incurred in the 
carrying out of his duties as an employee, but to make company funds 
available to the employee. The objective inference may be drawn from the 
circumstances of the employee's proprietorship, and power to make the 
decision regarding the payment of the expenses, in necessary combination, 
one would think, with an element of tenuousness in the relationship 
between the offence and the carrying out of duties as an employee. In 
Magna Alloys there were aspects of the circumstances that might have
yielded an objective inference that the purpose was simply to make the company's funds available to its directors. The conclusion of the Federal Court was that such an objective inference should not be drawn. Much of the discussion in the case concerned the bearing of the subjective corporate purpose in the decision of the directors. That discussion is more than persuasive that subjective purpose should have no bearing.

6.43 The analysis offered in the last paragraph, as appropriate in a case where the employer and the employee are not at arm's length, has wide implications. It would make ss 108 and 109 of the Act (considered below in [10.348]–[10.358]) largely unnecessary on the question of deductibility by a company of a payment to a shareholder or director, or to a relative of a shareholder or director. The relationship between the company and payee, coupled with other circumstances, in particular the commercial unreality of the payment, may yield an objective inference that a part of the payment was not for a purpose that gave it relevance. The analysis would make some other provisions largely unnecessary on the question of deductibility, such as s. 65 and s. 31C (considered below in [10.310]–[10.328] and [10.290]–[10.293]).

6.44 Where a business is carried on by a partnership, and the offence is committed by or alleged against a partner, deductibility in computing “net income” of the partnership under s. 90 will follow the analysis above in regard to deductibility by an employer.

6.45 Where an offence is committed by an employee or alleged against an employee, and the employee himself pays the penalty and expenses of defence there will be a question whether the employee is entitled to a deduction. Payment of the penalty is denied deduction by Madad Pty Ltd (1984) 84 A.T.C. 4739 and s. 51(4). Deductibility by the employee of the expenses of his defence, may be resolved differently from deductibility by the employer had he incurred expenses in the employee's defence. In the case of the employer, deductibility depends on relevance to business income. In the case of the employee it depends on relevance to employment income. The point has already been made that relevance to business income may be satisfied by a connection which would not satisfy relevance to employment income. It is not a matter of the unavailability to the employee of the second limb of s. 51(1). Relevance to business income may be established under the first limb in circumstances that would not establish relevance to employment income. The cases on self-education expenses incurred by an employee considered later in Chapter 8 ([8.38]–[8.56]) require that the action of the employee which gives rise to the expense whose deduction is claimed must have been something he was employed to do, if the expense is to be held relevant to employment
income. Alternatively the action must have “a direct effect on income”—a test of relevance which need not be examined here. Both tests reflect a disposition by the courts to be less than generous in finding employee expenses to be relevant. There may be a sound policy objective. The consequence for the Commissioner of a relaxed test of relevance could be catastrophic in the tax relief afforded. Analytically the question is the same whether the deduction is claimed by an employee or by a self-employed person—is the expense a natural or recognised incident of the income-earning activity? But something may not be a natural or recognised incident of activity as an employee and yet be a natural or recognised incident of activity as a self-employed person. Costs of defence of a charge of overloading a truck may be deductible where incurred by a self-employed driver. Costs in the same circumstances incurred by an employee driver may not be deductible, more especially if the employer has expressly forbidden overloading.

6.46 The question whether an employee who pays expenses himself is entitled to a deduction, is distinct from the question whether the reimbursement of the expenses by the employer is a derivation of income by the employee, and it is distinct from the question whether a direct payment of the expenses by the employer involves a benefit which is income of the employee under s. 26(e). Where the reimbursement is given under an arrangement by which the employee will be reimbursed, the expenses will not be deductible—there is no outgoing, though there may be an outlay, where an amount is paid in respect of which there is an entitlement to reimbursement. There may however be a loss if the entitlement to reimbursement fails to realise its cost: the employer may fail to meet his obligation to reimburse. If the reimbursement is a voluntary act by the employer—not dictated by any obligation to reimburse—the expenses incurred by the employee, if otherwise deductible, will have been deductible by the employee. The reimbursement will be income of the employee as compensation for a deductible outgoing under the compensation principle (Proposition 15, [2.506]ff. above) or under s. 26(j) ([4.204]ff. above). A direct payment by the employer of the employee's expenses poses problems of analysis of a kind considered in [4.75]ff. above and [8.53]ff. below in regard to direct payment of education expenses of an employee. There is no necessary correlation between the consequences of a direct payment by the employer that will attract for the employee the contribution to capital principle and the deductibility of a payment by the employee himself.

6.47 An employee who has paid the amount of a penalty imposed on him may receive reimbursement by his employer. The payment of the penalty
will be denied deduction under Madad and s. 51(4). The reimbursement will not be income of the employee under s. 26(j)—the receipt is not compensation for a deductible outgoing. It could however be income of the employee under the ordinary usage compensation receipts principle: the reimbursement is, possibly, compensation for an outgoing on revenue account, s. 51(4) being irrelevant to a conclusion on that issue. The employee may be able to escape an income characterisation of the reimbursement by relying on the contribution to capital principle. Certainly it would be considered fair that he should be so entitled. The employer is probably not entitled to a deduction of the payment in reimbursement. *Madad Pty Ltd* (1984) 84 A.T.C. 4739 does not expressly cover the situation, though it would be an appropriate extension of the rule there adopted. Section 51(4) may cover the situation: the reimbursement may be seen as a payment “in respect of” the penalty.

**The Characterisation of Damages and Expenses of Defence**

6.48 The characterisation of a payment of damages awarded in civil proceedings and the expenses of defence will follow in all respects, save one, the operation of s. 51(1) in relation to penalties. The only respect in which there may be a difference concerns the public policy rule confirmed in *Madad*, which may deny deduction where payment is made of a criminal penalty. Presumably there is no public policy principle which will operate to deny deduction of the payment of damages for a civil wrong. None was suggested in *Herald & Weekly Times Ltd* (1932) 48 C.L.R. 113 where the deductibility of criminal penalties is considered in the judgment of Gavan Duffy C.J. and Dixon J. (at 120). And, it was submitted in [6.28] above, s. 51(4) does not deny the deduction of a payment of damages in an action under the general law.

6.49 If moral enormity is not a ground for denying the relevance of an expense, as was submitted in [6.34] above, where a criminal offence is involved, it is not a ground for denying relevance where a civil wrong is involved. In *I.R.C. v. Great Boulder Proprietary Gold Mines Ltd* [1952] 1 All E.R. 360 there is an observation by Donovan J. in answer to a submission that damages had been paid by a company for fraud and deceit on its part, that “it is no part of . . . trading to be fraudulent and deceitful”. Donovan J. said (at 362): “If it is fraudulent and deceitful then the penalty it pays by way of damages cannot be deducted as a trading expense any more than could the penalty in *I.R.C. v. Alexander von Glehn & Co. Ltd* [1920] 2 K.B. 553.” The observation does not, it is submitted, state Australian law. What is a natural and recognised incident is judged by what
happens, not by what ought to happen.

**6.50** Where the liability in damages is incurred by the taxpayer himself or damages are claimed from him, deductibility of damages and costs depends on the degree of connection between the business carried on and the cause of the liability for damages (*Herald & Weekly Times Ltd* (1932) 48 C.L.R. 113 at 120).

**6.51** In *I.T.C. v. Singh* [1942] 1 All E.R. 362 the Privy Council held the expenses of successfully defending an action brought against the taxpayer, who was in business as a money lender, were not deductible. The action related to things done by the taxpayer in regard to a loan made in the carrying on of his business. Privy Council and United Kingdom cases need to be received with caution. Thus, in *Fairrie v. Hall* [1947] 2 All E.R. 141, in holding that damages for libel were not deductible, MacNaghten J. relied on the judgment of Rowlett J. in *I.R.C. v. E. C. Warnes & Co. Ltd* [1919] 2 K.B. 444 where the reasoning is coloured by the view that relevance should be judged by what ought to happen. Which is not to say that the facts of *I.T.C. v. Singh* would not give rise to the same decision in Australia. In *Fairrie v. Hall*, MacNaghten J. held that the damages for libel “fell on [that taxpayer] in the character of the calumniator of a rival sugar broker. It was only remotely connected with his trade as a sugar broker”. The reference to the loss falling on the taxpayer in the character of a calumniator adopts the kind of analysis made in *Strong & Co. Ltd v. Woodifield* [1906] A.C. 448. In that case it was held that damages awarded against the owner and operator of an inn were not deductible. The damages had been recovered by a customer injured by the fall of a chimney which was unsafe due to negligence of the taxpayer's employees in failing to see that the building was in a proper condition. Lord Loreburn said (at 452):

> "The nature of the trade is to be considered. To give an illustration, losses sustained by a railway company in compensating passengers for accidents in travelling might be deducted. On the other hand, if a man kept a grocer's shop, for keeping which a house is necessary, and one of the window shutters fell upon and injured a man walking in the street, the loss arising thereby to the grocer ought not to be deducted. Many cases might be put near the line, and no degree of ingenuity can frame a formula so precise and comprehensive as to solve at sight all the cases that may arise. In the present case, I think that the loss sustained by the appellants was not really incidental to their trade as innkeepers, and fell upon them in their character not of traders but of householders.”

The analysis in terms of character as householders is not helpful, save as a way of expressing a conclusion that the connection with income derivation was insufficient to give relevance to the expense. It is consistent
with *Strong & Co.* that damages for professional negligence paid to a client by a solicitor or doctor are deductible.

**The Characterisation of Losses Arising from the Deprivation of Assets where the Assets are the Taxpayer's own Property**

**The meaning of “losses”**

6.52 Some attention has already been given to the distinction between the word “outgoings” and the word “losses” used in s. 51(1) ([5.14]-[5.22] above). The class of expenses considered under the last heading were outgoings. The class of expenses now to be considered are losses. The expense arises from the deprivation of an asset, a deprivation which may arise from the “loss” of an asset by its being mislaid and remaining not found, by its destruction or by the wrongful appropriation of the asset by another—all “losses” in the sense that the items are lost to the taxpayer. But the expense is not the loss in this latter sense, but rather the loss in the sense of the failure of the asset to realise its cost, the failure arising from the mislaying, the destruction or the wrongful appropriation.

6.53 The deprivation of the taxpayer's own property is a different situation from the deprivation of property the taxpayer holds in trust for another. It will be seen that in the latter situation the expense that may be deductible is an outgoing—the cost of replacing the property in pursuance of an obligation resting on him as trustee. The cost of replacing the property will be an expense of a different amount from the loss expense that may be deductible by a taxpayer who is deprived of his own assets. The loss expense will be the amount of the cost of the asset, its historical cost—not the amount of the cost of its replacement, its present value.

**Assets mislaid and assets destroyed**

6.54 The cases, apart from *Guinea Airways Ltd* (1950) 83 C.L.R. 584, have been concerned with deprivation by robbery and misappropriation. Those cases, considered under later headings, must have a bearing on the resolution of the questions of relevance and working character where a taxpayer is deprived of assets by having mislaid them, or by their being destroyed.

6.55 The mislaying of an asset, its accidental destruction, or its wilful destruction by someone other than the taxpayer, may be a natural or recognised incident of an activity of producing income. If the event is thus relevant, there will be a loss that is a working expense, should the asset be a revenue asset. It will be apparent from earlier discussion that a finding of
a connection which is sufficient to make an expense a natural or recognised incident is not an exercise in logic: it is a matter of evaluation in the wide area between obviously inadequate connection and obviously adequate connection. *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290 and *Charles Moore & Co. (W.A.) Pty Ltd* (1956) 95 C.L.R. 344 indicate a willingness to lean towards an adequacy of connection, the willingness being expressed in a principle which justifies discounting the significance of the unusualness of the event.

6.56 *Guinea Airways* is concerned not with relevance, but with the character of the loss as a working loss and, in this regard, with the character of the asset as a revenue asset or a capital asset. The maintaining of a large stock of spare parts which is “beyond any requirements for prospectively immediate use” (at 590), in the view of Latham C.J., following Dixon J. at first instance, gave the spare parts the quality of capital assets, and the loss was thus a capital loss. Kitto J. held the spare parts were capital assets as items “acquired before they were actually needed” (at 592), an explanation which would make spare parts capital in much wider circumstances than those contemplated by Latham C.J. And the extension by Kitto J. of the same idea to cover cash kept in a safe to meet future needs is at odds with the view taken later in this Volume that cash, if held for use in the derivation of income, is always a revenue asset.

6.57 The assumption in *Guinea Airways* that the loss was a relevant loss—that destruction of spare parts by enemy action was a natural or recognised incident of conducting an airline—is in line with the conclusions on relevance in *Nevill*, and more especially, in *Charles Moore*. The unusualness of a particular event will not preclude relevance where the event can be seen as one of a broad class of events which may be regarded as natural or recognised incidents. Assets held for business purposes are exposed to risks of deprivation by being mislaid, or by destruction in many ways. The particular manner will not take it out of the class.

**Assets appropriated by strangers**

6.58 *Charles Moore* supports a view that the class of events involving appropriation of assets by strangers which will be regarded as having a sufficient connection to be relevant is very wide: “Even if armed robbery of employees carrying money through the streets had become an anachronism which we no longer knew . . . it would remain a risk to which of its very nature the procedure gives rise” ((1956) 95 C.L.R. 344 at 351).

6.59 None the less the case leaves unresolved a number of questions as to the bearing of the source of the assets, of which the taxpayer was deprived,
on the issue of relevance and on the issue of working character. The issues are run together: “We can see no reason why it should not be considered a loss incurred in gaining or producing the assessable income . . . and we do not think that it should be regarded as a loss or outgoing of capital or of a capital nature” (at 349). The judgment proceeds to make a number of observations which emphasise the source of the money in daily “takings”: “In the case of a large departmental store such as the taxpayer carries on, the ordinary course of business requires that, day by day and as soon as may be, the takings shall be deposited in the bank.” “Banking the takings is a necessary part of the operations that are directed to the gaining or producing day by day of what will form at the end of the accounting period the assessable income” (at 349–350).

6.60 The source of the assets held may have some bearing on the issue of relevance, though only an indirect bearing. The fact that the money of which the taxpayer has been deprived is “takings”, in the sense of the proceeds of sale of trading stock, is some evidence that the money was held in the process of deriving income and not privately so that the loss arising from the deprivation was a relevant experience, as distinct from a private or domestic experience. It is not of course definitive. If the taxpayer has taken money from his cash register in order that he might use it for private or domestic purposes and is then deprived of that money, his loss will not be relevant, whether or not he proposed to show the amount drawn in his financial or tax accounts. The money has lost its character as “takings”.

6.61 And there is no reason why being deprived of money which is the proceeds of sale of capital assets, or which is money borrowed on capital account, should not be treated as a relevant experience. It may be unusual to have money at risk to being stolen where that money is such proceeds, or is so borrowed, but the holding of that money may none the less be in the process of deriving income. A retailer, such as the taxpayer in Charles Moore, may receive moneys deposited by customers in response to an offer of debentures. Being deprived of takings of this kind in circumstances otherwise the same as in Charles Moore, is, it is suggested, a relevant experience.

6.62 Whether or not the deprivation gives rise to a loss of a capital nature is a distinct issue. And on this issue it may be doubted that the source of the moneys has any bearing, direct or indirect. Whether money is held as a revenue asset or as a capital asset must depend, not on its source, but on the circumstances of the holding. At some point the holding of money as cash, like the holding of the spare parts in Guinea Airways (1950) 83 C.L.R. 584, becomes a holding which is part of the structure of the business. A
taxpayer who stores money in his safe or hides it, whether to thwart the Commissioner or because he does not trust banks, may hold the money as a capital, not a revenue asset, but the source of the money has no bearing. “Money”, for purposes of this analysis, should extend to cash, and to money held in a current account so that it can serve as a medium of exchange. It is consistent with Charles Moore that the deprivation would have given rise to a deductible loss if the money, having survived the journey to the bank and been deposited in the taxpayer's current account, had been appropriated by someone who forged a cheque drawn on that account. A loss arising from the forging of a cheque on one's bank account is as much a natural or recognised incident of the process of deriving income, as a loss arising from armed robbery. And provided money is not held in the bank account in such an amount that it may be regarded as stored, like the spare parts in Guinea Airways, it should be regarded as a revenue asset and not a capital asset.

6.63 To allow source of the money to determine its character as revenue or capital, is to generate a confusion as exasperating as that escaped in Charles Moore, by the rejection of the argument made by the Commissioner that the deprivation could not be a loss in gaining income because it was a deprivation of income already gained.

6.64 The analysis followed in the preceding paragraphs has implications in regard to assets other than money. Trading stock may come to be held in such a way that a loss in relation to them is not a relevant loss. If the proprietor of a second hand car business takes a car from his stock and entrusts it to his daughter for her weekend use, or uses it himself for private purposes, the theft of the car while so used is not a relevant experience. The trading stock provisions are ill-designed to deal with a situation of this kind. Section 28 would wrongly allow a deduction, though not by design. Section 36 is not in its terms appropriate to correct the operation of s. 28. The United Kingdom decision in Sharkey v. Wernher [1956] A.C. 58 would provide a correction, but that decision may not be available to the Commissioner. It is, possibly, excluded by the provisions of s. 36. The matter is discussed in [14.59]ff. below.

6.65 Trading stock may come to be held in quantity analogous to the holding of spare parts in Guinea Airways. They may thus cease to be revenue assets, and thereafter be held as capital assets. A relevant loss by deprivation of them may thus be a capital loss. Again the trading stock provisions are ill-adapted to deal with a situation of this kind.

6.66 Deprivation is the occasion of a loss by the failure of the asset to realise its cost. The loss will be the amount of the cost. There may be an insurance recovery which, commercially, mitigates the loss. The insurance
recovery is however, at least in the view of Kitto J. in *Guinea Airways*, a
distinct event which may give rise to a derivation of income in the amount
of the insurance recovery: the recovery may be income under the
compensation principle (Proposition 15) and s. 26(j) (2.506]ff. and [4.204]
ff. above). The taxpayer's loss may be mitigated, commercially, by
recovery from the person who was responsible for the taxpayer's
depredation. There is a question whether this recovery should be treated as
negating deprivation, so that the loss that is deductible should be calculated
by bringing the recovery to account. The treatment of the recovery in this
way poses problems arising from the Commissioner's limited powers to
amend assessments (under s. 170) where deprivation and recovery occur in
different years of income. The alternative treatment, which would be the
more sensible, would treat the recovery as a distinct event, as in the case of
an insurance recovery, and as income under the compensation principle.
This treatment does, however, appear to be precluded by the decision in *H.
In *Sinclair* the moneys returned were received as income in the form of
business receipts (Proposition 14). But the availability of the *Sinclair*
principle in the circumstances presently considered may be doubted. There
is a reference in the judgment of Owen J. to the United Kingdom authority
in *English Dairies v. I.R.C.* (1927) 11 T.C. 597 which may suggest that it is
not a business receipt for the taxpayer to receive back money which has
been illegally taken from him.

**Acts of deprivation by employees or agents**

6.67 *Ash* (1938) 61 C.L.R. 263 and *Levy* (1960) 106 C.L.R. 448 remain the
Australian authorities where deprivation results from the act of an
employee or agent. The issues of relevance and working character again
tend to be run together in the cases. And there appears an additional reason
why a loss may fail to have a working character. The employee or agent
may be a managing director of a company taxpayer, or a partner of the
taxpayer, and the loss treated as not working but capital.

6.68 On the issue of relevance, *Levy* is simply at odds with *Charles Moore & Co. (W.A.) Pty Ltd* (1956) 95 C.L.R. 344, though Kitto J. referred to
*Charles Moore*. The loss arose from the forging of cheques on the bank
account of the firm in which the taxpayer was a partner. The forging was
by an employee, not of the taxpayer's firm, but of a firm of accountants
who were engaged to write up the books of the taxpayer's firm. Kitto J.
expressed the view that no deduction of the loss arising from the forgeries
was allowable under s. 51. He said: “. . . the defalcations would have had
to be a kind of misfortune which was a material or recognised incident of the partnership: cf. *Charles Moore* . . . ; and the facts disclosed as to the nature of the business, the position of [the employee of the accountants] and the method by which [he] effected his defalcations, were quite sufficient to make it clear that the deduction could not possibly be supported on this basis” ((1960) 106 C.L.R. 448 at 458). One would have thought that forgery by an insider is, a fortiori, a natural or recognised incident if armed robbery by an outsider is such. The method by which the forgeries were concealed was commonplace. In any event *Charles Moore* would discount the unusualness of the method of deprivation, if the particular method of deprivation is of a class that is a natural or recognised incident.

6.69 The reference, in the passage quoted from the judgment of Kitto J., to the position of the forger—an employee of the accountant engaged to write-up the books—is presumably intended to bear on the issue of relevance only. As such, it is the more difficult to reconcile with *Charles Moore*. One could understand a view that forgery by a person who is not an employee of the taxpayer is insufficiently connected with income derivation, though the technicalities of a distinction between an employee and an agent seem rather remote from the more significant matter of the opportunities for acts of deprivation offered by the task the employee or agent is asked to perform. But that view can hardly be supported when robbery by a stranger is held to be sufficiently connected.

6.70 *Levy*, in relation to s. 51(1), does not examine the revenue or capital nature of the money that was taken by the forger. The case is not inconsistent with the view that money in a current account will generally be of a revenue nature. Nor does the case direct attention to the source of the money in the account as relevant to the nature of that money. The language of s. 71 (discussed by Kitto J. but not in this respect) might have suggested that source is of cardinal importance. Section 71, as then and as now drafted, allows a deduction of a loss “in respect of money that is or has been included in the assessable income of the taxpayer”. The drafting would support an inference that might be drawn from *Charles Moore*, namely that the revenue or capital nature of the money of which the taxpayer has been deprived depends not on the way in which the money is held, but on whether the derivation constituted by the receipt of the money was on revenue or capital account. *Charles Moore*, in this regard, and s. 71, confuse distinct notions. Income is a quality of derivation. It is not a quality which attaches to what may be received in the event which constitutes derivation. It may be convenient and acceptable to say that an item received is income: it avoids abstraction. But it is simply confusing if
this language is allowed to determine the character, as a revenue asset rather than a capital asset, of what is received. Revenue or capital in this context is a matter of how the asset is held. An architect receives a motor car in payment for services rendered to a client and uses the motor car in his business. The receipt of the motor car is a derivation of income, and it is convenient to say that the motor car is income. But the motor car is a capital asset of the architect's business.

6.71 Ash (1938) 61 C.L.R. 263 is a source of the statement of principle governing relevance which requires that the outgoing or loss must be a “natural or recognised consequence or incident” of the process of deriving income, and the judgments approach the decision in the case in terms of relevance, rather than in terms of the working character of the expense. The taxpayer, now in practice alone as a solicitor, had been in partnership with another who had misappropriated moneys belonging to clients or had defrauded clients, and taken the proceeds of his fraud for himself. The expenses for which deductions were claimed were payments, to the clients of the partnership, of the amounts misappropriated, or obtained by the former partner from his frauds. The case thus involved a claim to deduct not a loss but an outgoing. None the less all the judgments assume that the initial question to be answered was whether the act of the former partner was relevant to income derivation by the partnership, and this in turn led to the drawing of a distinction between misappropriation of partnership assets by a partner and misappropriation by employees.

6.72 Dixon J. said (at 281): “If a proprietor of a business converts its funds to his own use or uses the opportunities the business affords to defraud its clients or customers, his resulting liability cannot be considered an outgoing of the business, still less an outgoing on revenue account.” The statement includes a number of propositions, some acceptable and some not. The act of a proprietor in converting business funds to his own use—presumably by spending them on private consumption—does not involve a relevant loss or outgoing. There is no loss, and so far as there is an outgoing, it has no connection with the process of deriving income—it is a private or domestic outgoing. If a proprietor converts to his own use money obtained by a fraud on clients, the same observations are appropriate. If he converts to his own use money he holds in trust for clients there is no business loss or outgoing. There may be a relevant outgoing arising from the liability to replace the trust funds but this would not be a working expense—it concerns the defence of the business in a situation of peril and may be described as capital. The liability to recompense clients from whom money has been obtained by fraud may give rise to a relevant outgoing. Whether such an outgoing has a working character will depend
on the operation of principles examined above in [6.48]-[6.51]. A liability of this kind, in contrast with the liability in *Herald & Weekly Times Ltd* (1932) 48 C.L.R. 113, may not have a working character: it may be thought to go to the defence of the business in a situation of peril.

6.73 The first proposition dissected out of the statement of Dixon J., and accepted as correct, is the important one for present purposes. There is no loss and, so far as there is an outgoing, the outgoing is private or domestic. It is not a matter, as other judgments in *Ash* might make it appear, of whether dipping into the till for private or domestic expenditure by a proprietor is any more or less a natural or recognised incident of the conduct of a business, than is dipping into the till by an employee. Any suggestion that the former is not, while the latter is, reflects some kind of snobbery and not an assessment of fact. Some such suggestion emerges from the judgment of Latham C.J. who referred to the United Kingdom decision in *Curtis v. Oldfield* (1925) 9 T.C. 319. The managing director of a company had treated company funds as his own and had taken from those funds for his own use. The company, after his death, sought to write-off as a bad debt the amount of his liability to the company to restore money so taken. After conceding that the failure of receipts “to find their way into the till” due to dishonesty of “subordinates” is an expense of the trade, Rowlatt J. said (at 331): “This gentleman was the managing director of the company, and he was in charge of the whole thing, and all we know is that in the books of the company which do exist it is found that the moneys went through the books into his pocket. I do not see that there is any evidence at all that there was a loss in the trade in that respect.” So expressed, the judgment of Rowlatt J. leaves the impression that the tax consequences of misappropriation by an employee will differ, depending on whether the employee is a superior or subordinate. What was important in *Curtis v. Oldfield* is that the managing director had been a substantial shareholder in the company, so that the misappropriation might be seen as appropriation by a proprietor, which, if treated as an outgoing because of the separateness of the corporate entity, would none the less be a capital outgoing, in the sense in which dividends paid by a company may be regarded as capital outgoings.

6.74 The suggestion which emerges from the reference to *Curtis v. Oldfield* is corrected by the statement at the end of the judgment of Latham C.J. that “. . . fraud of a partner is a business risk. But the loss is a capital loss and expenditure made for the purpose of meeting or retrieving the loss is a capital expenditure” *Ash* ((1938) 61 C.L.R. 263 at 275).

6.75 A suggestion that misappropriation by a superior is less likely to be relevant than misappropriation by a subordinate may be drawn from the
statement in the judgment of Rich J. in *Ash* (1938) 61 C.L.R. 263 at 278 that “you cannot treat . . . the depredations of a partner as if they were the peculations of an office boy”. The suggestion is however corrected by the later statement that “the partner was a proprietor”.

**The time when the loss is incurred**

6.76 Whether the deprivation of assets results from action of an outsider or an insider, the moment of incurring of the loss will be the moment when the deprivation occurs. If any amount is subsequently recovered from the person whose actions brought about the deprivation, there will be a need to determine the character of the amount recovered. *H. R. Sinclair Pty Ltd* (1966) 114 C.L.R. 537 and the discussion in [2.547]ff. above are relevant.

6.77 Deprivation may not be discovered immediately: there was a considerable delay in *Levy*. Where the taxpayer has already been assessed in respect of the year in which the deprivation occurred, he will have to rely on the Commissioner's exercise of his power to amend the assessment so as to allow the deduction of the expense. The Commissioner's power to amend is limited by s. 170(4) and the taxpayer may be denied an amendment to allow the deduction. In these circumstances, the taxpayer may be able to call on the specific provision in s. 71 which allows a deduction in the year in which the loss is “ascertained”. Section 71 is considered further in [10.84]-[10.87] below.

**The Characterisation of Outgoings arising from the Deprivation of Assets held in trust by the Taxpayer**

6.78 The discussion of *Ash* and *Curtis v. Oldfield* (in [6.71]-[6.75] above) has endeavoured to show the significance of the circumstance that the assets of which the taxpayer has been deprived were held in trust by him. The deprivation of the asset is not a loss incurred by the taxpayer. There will however, in some circumstances, be an obligation on the taxpayer to compensate the trust fund, and the arising of this obligation, or the transfer of property from his own resources in discharging the obligation, will be an outgoing incurred by the taxpayer. So too a voluntary transfer of property to compensate the fund will be an outgoing incurred. The issue of deductibility thus relates to the outgoing in transferring property to compensate the fund, or in the direct compensation of the beneficiary.

6.79 The outgoing may be a relevant outgoing notwithstanding that the deprivation was the act of an outsider, an insider, or, indeed, a proprietor of a business which held the assets in trust. In *Ash* the payments in
compensation to those whose property had been misappropriated by the taxpayer's partner were relevant but not working: they were capital outgoings. They were capital because their function was to meet an obligation arising from an appropriation of the assets of clients by the proprietor of the business. At least this would be the characterisation if the partner who had appropriated had remained a partner. In fact he had ceased to be a partner, and the payments were by the new sole proprietor of the practice. The denial of the deduction could be explained, if other grounds are thought unavailable, by the contemporaneity principle. The outgoings, if identified as the actual payments to clients, were made at a time when the business of practice in partnership had ceased. The outgoings could only escape the contemporaneity doctrine if they could be identified as outgoings that might be allowed in computing the net income of the partnership for purposes of s. 90.

6.80 Where the deprivation arises from the act of some person other than a proprietor, the outgoing in restoring the fund or in direct compensation of the beneficiary may be both relevant and have a working character. The relevance issue raises again the scope of Levy and Ash. In C. of T. (N.Z.) v. Webber [1953] N.Z.L.R. 107 an outgoing in direct compensation of the client for whom the asset had been held was treated as deductible. A solicitor taxpayer had been induced by the fraud of his clerk to lend his client's money. The loan could not be recovered and the taxpayer compensated the client. The issue of working, as distinct from capital character, of the outgoing raises questions already considered in relation to the deductibility of damages and expenses of defence. There will be circumstances in which a payment such as that made in Webber will be held to be capital as a payment in defence of the business structure. A distinction can be drawn between the nature of the payment in Herald & Weekly Times and a payment by a solicitor in settling a claim that involves an allegation of serious impropriety in the care of a client's funds. None the less, a payment in settlement of a claim that involves an allegation of professional negligence is not necessarily denied deduction. Snowden & Willson Pty Ltd (1958) 99 C.L.R. 431 has some bearing. The size of the payment should not determine the character of the payment, though size of the payment may be the reason why the question of deductibility has been raised. The size of the payment was substantial in Webber—£NZ2,000 in the 1940s.

The Characterisation of Interest, Rent, Rates or Repairs that Relate to Assets of a Business, or to Property Whence Income is Derived
6.81 Precise analysis requires the drawing of a distinction between the relevance of an expense and the working character of that expense. Relevance, it will be seen, depends on the use made of the money to which the interest relates, or the use made of the property to which the rent, rates and repairs relate. The use must be in some process of income derivation. Working character, it will be seen, depends on the maintenance character of the expense—on its function in servicing the money borrowed or the property to which the rent, rates and repairs relate. The fact that the money borrowed is invested in a capital asset or the property is a capital asset will not deny the interest, rent rates or repairs their maintenance character. A service expense of these kinds is a working expense just as an expense for insurance against damage to a capital asset by fire may be a working expense. In a related field there is a distinction to be drawn between a premium paid for insurance of one's title to property, and a payment in defence of proceedings which challenge one's title to property. The former may be deductible as maintenance expenses, while the latter, if the assets are capital assets, may be denied deduction because they are not maintenance but capital expenses.

6.82 Whether the issue be relevance or maintenance character, any determination of purpose, it is assumed, will be made objectively. The observations in [6.2]-[6.17] above are relevant.

6.83 Deductibility of interest, rent, rates and repairs is an area of the operation of s. 51 where one might have expected the extended form approach, taken by the courts in other areas, to be applied. It will be recalled that a primary form approach insists that where terms of legal art have been used in the words of a tax statute, and the taxpayer's actions place him fairly within or without those words, he will be advantaged or disadvantaged as the statute directs whatever might be considered to be the policy of the statute. A taxpayer who was the equity participant in a leveraged lease prior to the amendments announced in December 1981, was entitled to the investment allowance as an owner notwithstanding that, the lessee being a State Government, it could not have been the policy of the investment allowance provisions to give the allowance. The extended form approach gives a greater significance to form. It insists that where terms of legal art have been used by courts in framing rules to give effect to words of a statute which have not used terms of legal art, a taxpayer whose actions place him fairly within or without the words used by the courts will be advantaged or disadvantaged as the statute directs, whatever might be thought to be the policy of the statute. Illustrations of an extended form approach, where the statute merely uses the word income, were noted in Chapter 2, [2.420]ff. above. The extended form approach in its...
application to the words of s. 51(1) has already been the subject of some comment in [6.6]-[6.9] above. It is in the s. 51(1) context that another approach, associated with a form approach has been most evident. By this associated approach the courts have put limits—blinders—on what may be looked at in determining whether form is complied with. Thus a rule of extended form is asserted that an expense for the purpose of acquiring trading stock is deductible. The further assertion is then made that the purpose of an expense which arises under a contract may be found only in the terms of the contract, so that, for example, the purpose of a payment under a contract which provides only for the supply of trading stock must be the obtaining of that supply. The principal manifestations of blinkers are in *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430 and *Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2)* (1976) 76 A.T.C. 6001. They relate to acquisition of trading stock. *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645 is a qualified application of blinkers in relation to payments by way of rent. It is qualified in ways explained in [9.19] below.

6.84 There are special difficulties about the application of blinkers in the contexts of interest, rent, rates and repairs. It will be seen that the rules formulated in judicial decision make deductibility depend not only on the outgoing having been incurred for the purpose of maintaining property, but also on the property maintained being outlaid or employed for the purpose of deriving income. The rules thus require a composite of two purposes. Both the outgoing in maintaining and the outlay or employment of the property may have been the subject of contracts. Where this is the case, there is the prospect of the application of blinkers at two points. In *South Australian Battery Makers* there was simply no dispute about the employment of the property. In any event its employment did not involve another contract. In *Ure* (1980) 80 A.T.C. 4264, however, at first instance, Lee J. considered that he was bound by the blinkers approach not only in regard to the maintenance purpose of the payments by way of interest, but also in regard to the purpose in laying out the moneys borrowed by lending them to associated persons: the on-lending was under further contracts. He reached his conclusions on the purpose of the laying out within a view of the facts made somewhat wider by the qualification on the blinkers approach established by the judgment of Gibbs J. in *South Australian Battery Makers*. In the Federal Court in *Ure* the possible application of blinkers in regard to the purpose of the on-lending is simply ignored. The reason may be that blinkers had been ignored in the same way in *Total Holdings (Australia) Pty Ltd* (1979) 79 A.T.C. 4279. If it had been applied in *Total Holdings* in determining the purpose of the on-lending to the subsidiary at no interest, the consequence would, presumably, have been
the defeat of the taxpayer: a loan at no interest does not show any laying out for the purpose of deriving income. A conclusion that the laying out was for the purpose of deriving income required speculation about dividends that might be paid by the borrowing company to the taxpayer, and about the taxpayer's intentions to continue to hold its shares in the borrowing company, rather than sell them at a gain which would not be income.

6.85 The ignoring of the blinkers approach in *Ure* and *Total Holdings* in relation to the on-lending may dictate a re-examination of the approach generally, so as to question *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers*. Meanwhile it seems that, however valid the blinkers approach may be where the issue is whether payment of interest is for the purpose of servicing a borrowing, the approach is not valid where the issue is whether the outlay or employment of the money borrowed was for the purpose of deriving income.

Interest

6.86 The case law assumes that there is a rule, though it is variously formulated, which will determine whether payment to service a loan of money is relevant and working. Relevance and working character, here as in other contexts, tend to be run together. Thus in the proceedings at first instance in *Ilbery* (1981) 81 A.T.C. 4234, Smith J. accepted a proposition put to him by the taxpayer that “interest on moneys which are borrowed for the purpose of acquiring an income producing asset is deductible” (see (1981) 81 A.T.C. 4661 at 4665 per Toohey J.). By such a formulation of the rule, the purpose of the laying out may connect the payment of “interest” with the derivation of income and make it relevant. If the legal form of “interest” is met, the payment, if relevant, will be a working or maintenance payment, and will be deductible. In the latter respect an extended form approach has been taken. At least it was taken by Smith J. in *Ilbery*. In the Federal Court it was taken, with some reservation, by Toohey J. The reservation is in the statement: “It is, I think, necessary to distinguish between the prepayment of interest in the present case and the character that payment would have if spread over a number of years as interest on money borrowed for the purpose of purchasing a property as a source of income. The character of the one does not necessarily determine that of the other” ((1981) 81 A.T.C. 4661 at 4668). It will be seen that the denial of deduction of the interest payment by Toohey J. resulted from the application of the contemporaneity principle considered in [5.37]-[5.48] above. It was not therefore necessary for him to pursue his reservation, and
consider the submission put to him by counsel for the Commissioner that a prepayment of interest, lacking a recurrent character, must be on account of capital rather than revenue. Such consideration as he gave to the matter suggests that, contrary to his reservation, he would regard any payment which is in form interest as a working expense if it relates to money outlaid for the purpose of acquiring an income-producing asset. If an extended form approach centring on the word “interest” in judge-made rules is not taken, it will be possible to conclude that a pre-payment of interest is not a working but a capital expense. It is an expense of obtaining a lasting advantage—the use of money for an extended period without the need to service it by paying interest, or subject only to service at a reduced rate of interest. Deductibility will then depend on the existence of provisions, in sections other than s. 51(1), which, like the depreciation provisions, would allow deductions by way of amortisation of the pre-payment over the life of the advantage gained—the period of the borrowing. In fact there are no such provisions in the Assessment Act. The outgoing to obtain the tie with a garage proprietor for a period of years, held capital in *Strick v. Regent Oil Ltd* [1966] A.C. 295, would not attract any amortisation provisions under the Assessment Act.

6.87 If extended form is attracted by the use of the word “interest” in formulations of a rule by which the deductibility of payments to service a loan will be determined, form will govern only to the extent that the payments are within the word as a term of legal art. A description, in the contract, of the payments in *Cliffs International Inc*. (1979) 142 C.L.R. 140 as “purchase price” did not preclude a different characterisation. There is no suggestion in *Ilbery* that an advance payment of the kind with which the case was concerned is not within the word as a term of legal art, though there might be room for a submission that it was not. The fact that payments are called interest is not enough to make them interest, even when they are called interest in a contract which attracts the blinkers approach, though that approach might of course confine the characterisation of the items called interest to inferences from the terms of the contract.

6.88 The room for an extended form approach is in other respects limited by a want of agreement in judicial statements on the rule expressing s. 51 (1) in the context of interest payments. If extended form were applied to the rule accepted by the judge at first instance in *Ilbery*, the rule would allow the deduction of interest on moneys borrowed for the purpose of acquiring an income producing asset whether or not the moneys borrowed have been laid out for that purpose. Such a rule would exclude the operation of the contemporaneity principle held in other cases to be
expressed in s. 51(1). The Federal Court by asserting the contemporaneity principle in denying a deduction to the taxpayer, has rejected the rule accepted at first instance.

6.89 If one were to try to frame a rule embracing all the requirements for which there is some judicial support, it would assert that interest is deductible if:

(i) There is a borrowing for the purpose of making an outlay which is for the purpose of deriving assessable income, so that one can trace through purposes; and
(ii) the money borrowed can be traced through movement of funds into an outlay that involves assessable income derivation; and
(iii) the money is currently so outlaid; and
(iv) the payment of interest relates to the use of the money, during the year of income, in the current outlay for the purposes of income derivation; and
(v) the payment of interest is contemporaneous with the income derivation; and
(vi) the payment of interest is made for the purpose of servicing the borrowing.

No rule can express the judicial interpretation of s. 51(1) unless it requires that the money borrowed should have been in fact laid out for the purpose of producing income. But its detailed formulation in a number of other respects needs to be settled, if there is to be a rule which in all its terms can attract extended form. Thus there will be need to know whether there must be a purpose at the time of the borrowing to outlay the money in order to produce income. If such a purpose is necessary, some arbitrary limitations on the deductibility of interest payments will result. A taxpayer who borrows to acquire property which will be income producing will be entitled to a deduction. A taxpayer who borrows to acquire property which will not be income producing, but which is later used to produce income, will not be entitled, at any time, to a deduction. Some of these matters are considered below in dealing more closely with Munro (1926) 38 C.L.R. 153, Total Holdings (1979) 79 A.T.C. 4279, Ure (1981) 81 A.T.C. 4100 and Ilbery (1981) 81 A.T.C. 4661.

6.90 If the question as to when the purpose of laying-out to produce income must subsist is answered, other questions remain. Granted that it must have been possible to trace the money borrowed into the outlay, there is a question whether deductibility is defeated if property into which the outlay is traced ceases to be used to produce income. It would be generally assumed that in these circumstances any entitlement to deduction will cease. And it would be generally assumed that if the asset used to produce income is disposed of, there will not be any entitlement to a deduction unless there is an outlay of any proceeds of the disposition that may be said to represent the money borrowed, and that outlay may be said to relate to
Where the moneys borrowed have been borrowed for the purpose of investment in business assets, or in property whence income will be derived, and the moneys can be traced through movement of funds into some asset, perhaps traced through several movements to and from other assets, the problems are easier. Tracing through purposes, and tracing through movement of funds into assets producing income can both be satisfied. But moneys borrowed may be used in the making of outgoings—meeting the running expenses of a business—which thereafter precludes any identification of the moneys borrowed in any assets. In these circumstances an acceptable rule determining when interest is deductible may not be easily stated. A sole trader borrows and uses the money borrowed to meet running expenses of his business. Thereafter he draws on the business bank account in order that he might have funds for private purposes. Does the “washing” of the money borrowed through the business ensure continuing deductibility of interest payments? A company borrows in order that it might have funds to pay a dividend. It may be doubted whether the interest on the borrowing is at any stage deductible: at no stage is the money borrowed laid out to produce income. Should it make any difference that the money was borrowed to meet outgoings, so that other funds might be used to pay the dividend? Other questions may be posed which may lead one to despair about ever stating an acceptable rule, indeed to despair about ever achieving coherent and consistent application of s. 51 (1) in relation to payments of interest, however free one might be to apply the words of the statute without the incubus of judge-made rule.

There is much to be said for a view that would not seek to trace the money on which interest is paid into the money outlaid to produce income, whether it be a tracing through purposes, a tracing through movement of funds, or a tracing which requires both a matching of purposes and a movement of funds. This view would leave the deductibility of interest to rest on the purpose of the borrowing—a purpose, it will be recalled, to be determined objectively and perhaps the better identified as function. The issue would be whether the function of the borrowing is to support the process of income derivation—the conduct of a business or the holding of property whence income is derived—and whether it continues to have that function. In the characterising of a borrowing for purposes of the application of the law as to exchange gains and losses, an approach that does not seek to trace is, it seems, appropriate, though the character of the borrowing that must be shown differs from the character that would justify interest deductions. It does seem absurd that interest on a borrowing on the security of a rented house, to finance the acquisition of a house that will be
used as a home, should be denied deduction, though interest on a borrowing on the security of a private home to finance the acquisition of a house that is rented should be allowed deduction. The test of support for the process of income derivation is, of course, vague and indeterminate. Any attempt to make it determinate is likely to end with a rule which would allow deduction of any interest payments in the proportion of the value of a taxpayer's assets producing income to his total assets. Such a test would, however, encourage borrowing through an interposed entity (partnership, trust or company) which might be thought to distort its operation.

6.93 A study of attempts to apply s. 51(1) in relation to the deductibility of interest brings a conviction that the only way to achieve consistent, if not coherent, application of the law is to allow deduction of any interest, whatever the destination of the moneys borrowed. This would be the United States solution. The alternative is to deny deduction of any interest, equating it with a distribution of income, an alternative favoured by some economists.

6.94 Munro (1926) 38 C.L.R. 153 is regarded as establishing a tracing requirement if interest is to be deductible—that the money borrowed must be shown to have been outlaid in new investment in business assets, or in the acquisition of property whence income is derived. Certainly the case requires a tracing through purposes, but it does not necessarily establish that there must also be a tracing through the actual movement of funds. If a taxpayer borrows in order that he might have funds to finance a new investment in business assets or to finance the acquisition of property whence income will be derived, it may be appropriate to treat the money borrowed as so outlaid, whether or not the actual funds outlaid are the funds obtained by the borrowing. The insistence on tracing through purposes appears to preclude a view that would regard a tracing through movement of funds as sufficient. It thus precludes a view that would allow the deduction of interest on money borrowed for a private purpose, if it can be shown by tracing through movement of funds that the money was in fact used for new business investment or in acquiring property whence income is derived. And it precludes a view that would allow the deduction of interest on money borrowed for investment in property used for a private purpose if the property so used is later used for business purposes, or as property whence income is derived. There is a suggestion in the judgment of Mason J. in Handley (1981) 148 C.L.R. 182 at 195, that deduction of interest in these circumstances is denied. In these respects, the consequences of Munro may be thought unsatisfactory. And the consequences may be thought the more unsatisfactory, if there is drawn out
from the case an inference that once the money borrowed has been invested in business assets or in assets producing income, interest on the borrowing will continue to be deductible even though the investment has been withdrawn, or the asset ceases to be used in a process of income derivation.

6.95 *Munro* (1926) 38 C.L.R. 153 was concerned with a borrowing secured by a mortgage on rent-producing property. The money was borrowed by the taxpayer for the purpose of investment in shares in a newly promoted company, and for the purpose of a loan interest-free to that company. 18,000 of the shares were allotted to the taxpayer's sons, and 2,000 to the taxpayer. The taxpayer was denied any deduction for interest on the money he had borrowed. The case was decided on the pre-1936 Act. In contrast with the present Act, the pre-1936 Act provided expressly for the deduction of “interest actually incurred in gaining or producing the assessable income” (s. 23(1)(a)). It thus opened the way to a primary form approach. The pre-1936 Act differed from the present Act in another way: it contained an express prohibition against any deduction in respect of “money not wholly and exclusively laid out or expended for the production of assessable income” (s. 25(e)).

6.96 Knox C.J. said (at 171): “The debt [for the money borrowed] having been incurred for a purpose wholly unconnected with the production of assessable income [of the taxpayer], I think it impossible to say that the interest paid on the amount of the debt was money wholly and exclusively laid out or expended for the production of his assessable income.” The conclusion that the money had been borrowed for a purpose wholly unconnected with the production of assessable income of the taxpayer went further than was necessary. To the extent that the money borrowed was invested in shares issued to the taxpayer there was a connection with the dividends that the taxpayer might receive on those shares. And the loan to the company might be seen as in part connected with those dividends. The conclusion is indeed in some conflict with the conclusion reached in *Total Holdings (Australia) Pty Ltd* (1979) 79 A.T.C. 4279 considered below. The judgment of Knox C.J. none the less proceeds on a rule that connection with the derivation of income that will make interest payments relevant is established where the borrowing is for the purpose of an investment that will produce income, and that investment is in fact made.

6.97 The judgment of Isaacs J. contains suggestions of a general principle that an outgoing, to be deductible, must in some sense have generated income. Such a general principle has been rejected by later cases referred to in [5.34] above. His judgment in other respects assumes a rule of tracing through purposes (at 198): “The interest paid in respect of the loan follows
accessorily the purpose of the principal sum.”

6.98 The judgment of Starke J. assumes a rule of tracing (at 218): “It was not an outgoing by means of which the taxpayer procured the use of money whereby he made any income.”

6.99 The issue in Total Holdings was the extent of the loss available for carry forward by the taxpayer company. The extent of the loss depended on the deductibility of interest payments at a rate of 3 per cent made by the taxpayer to its French holding company in respect of borrowings from the holding company held to be for a number of purposes:

(i) for the purpose of financing the operations of the taxpayer;
(ii) for the purpose of investing in the shares of a company (TAL) which at the time of the investment was its wholly-owned subsidiary, but which for a time thereafter became the wholly-owned subsidiary of another company in which the taxpayer owned half the shares;
(iii) for the purpose of lending to TAL, while it was a wholly-owned subsidiary, on demand at no interest; and
(iv) for the purpose of lending to TAL on demand with interest at 7 per cent, at a time when it was wholly-owned by the company in which the taxpayer owned half the shares.

Spending in its own operations, investments in shares in TAL and lending to TAL were in fact made by the taxpayer, and there was no dispute that the borrowings from the French holding company were for these purposes. Tracing through purposes was thus established, and there was no question raised about tracing through movement of funds. The reference in the judgment of Lockhart J. to moneys borrowed “which were in turn, or their monetary equivalent was used by the taxpayer” suggests a view that tracing through movement of funds is not essential. The Commissioner's apportionment of the interest paid on the loan from the French holding company between the several purposes was not disputed. The case was concerned only with the deductibility of interest on the borrowings from the French holding company so far as those borrowings were to be traced into loans made to TAL without interest, and which continued to be loans without interest. The Commissioner did not dispute deductibility of interest so far as the borrowings were to be traced into financing of the operations of the taxpayer, or into investments in shares in TAL, or into loans to TAL which were at 7 per cent interest, or, by renegotiation of terms, had become loans at 7 per cent interest.

6.100 The Commissioner's action in not disputing deductibility of the interest paid to the French holding company, in the respects just mentioned, calls for some comment. The assumption in allowing a
deduction of interest on borrowings used in the operations of the taxpayer's business is that it is not necessary, in order to establish deductibility, that it should be possible to trace the borrowings into assets of the business. The assumption, it was explained in [6.91] above, opens the prospect of washing borrowings by their consumption in business expenses, so that interest on them is deductible, and the use of other moneys to make a distribution to the proprietor or shareholder. The view was taken in [6.91] above that interest on a borrowing raised to enable a company to pay a dividend is not deductible.

6.101 The assumption in allowing a deduction of interest on a borrowing for the purpose of investment in shares is, apparently, that such a purpose is always to be regarded as a purpose of income derivation. Munro (1926) 38 C.L.R. 153 is not consistent with such an assumption. It will be recalled that the money borrowed in that case was outlaid by the taxpayer partly in the acquisition of shares by the taxpayer in a newly formed company, partly in the acquisition of shares by the taxpayer's sons in that company, and partly in a lending interest free to that company. It might have been thought that the outlay in the acquisition of the shares by the taxpayer, and the outlay in the interest free loan (in proportion to the taxpayer's shareholding in the company), were outlays for the purpose of income derivation by the taxpayer in the form of the dividends he might receive from the company. However, Knox C.J. said (at 171):

“The interest was paid, not for the purpose of gaining or producing assessable income of the taxpayer, but for the purpose of satisfying pro tanto a debt which the taxpayer had incurred with a view, not to the production of his assessable income, but to the production of income by the company for the benefit of its shareholders.”

Munro is of course a decision on the pre-1936 Act, involving legislation which prohibited a deduction of “money not wholly and exclusively laid out or expended for the production of assessable income”, but the statement by Knox C.J. in the passage quoted, if accepted, would support a denial of the deduction under the present Act of interest on moneys invested in shares.

6.102 One would have thought that in Total Holdings (Australia) Pty Ltd (1979) 79 A.T.C. 4279 the deductibility of interest on borrowings used to acquire shares in TAL would stand or fall with deductibility of interest on borrowings used to make interest free loans to TAL. For this reason, if for no other, the assumption by the Commissioner in regard to the deduction of interest on borrowings to finance share acquisitions, is difficult to follow.

6.103 The assumption that interest was deductible on a borrowing used to lend to TAL at 7 per cent interest may have been appropriate on the facts—7 per cent was presumably a commercial rate of interest at the time. Ure (1981) 81 A.T.C. 4100, it will be seen, is authority that it is not enough to
make interest deductible on the moneys borrowed that they are on-lent at more than a zero rate of interest. The Commissioner's assumption, as it is stated by Lockhart J. in *Total Holdings* (at 4284), is obviously too wide:

“The Commissioner concedes that, if the advances were made with interest, there would be a relevant nexus between moneys received from CFP and moneys advanced to TAL, because the interest paid on the loan from CFP of 3 per cent would be measured, to some extent, the exact proportion not being relevant in the Commissioner's view, by the interest received from TAL.”

6.104 The Commissioner's assumption that interest became deductible on a borrowing used to make a loan at no interest, when the loan was renegotiated so as to become a loan at 7 per cent interest, is no doubt good sense, but as explained in [6.94] above, it is not clearly supported by the authorities. In describing the Commissioner's admissions, Lockhart J. (at 4283-4) made no reference to the situation of the renegotiated loans to TAL: “Nor does the Commissioner deny the taxpayer the deductibility of interest paid to [the French holding company] on moneys lent by it to the taxpayer which were, or the monetary equivalent was, then lent to TAL with interest at 7 per cent per annum.” An inference from the emphasis in the words “then lent”, and the absence of any comment on the wider admission in fact made by the Commissioner, may be that Lockhart J. would have rejected the wider admission if he had been given the opportunity.

6.105 *Total Holdings* was concerned with the deductibility of interest on borrowings from the French holding company, so far as those borrowings were to be traced into loans made to TAL without interest, and which continued to be loans without interest. A purpose to borrow and lend at no interest does not show on its face a connection between the payment of the interest on the borrowing and a process of income derivation. The finding of a purpose which will connect the payment of interest with a process of income derivation, requires that one go beyond the making of the loan. Lockhart J. (with whose judgment the other members of the Federal Court agreed), in going beyond the loan, relied on evidence given by a witness who was a director of TAL and of the French holding company. The witness gave evidence as to his own state of mind, and of conversations with a director of the taxpayer going to the latter's state of mind. This reliance might suggest that the purpose of an outgoing by way of interest, which “follows accessorially the purpose of the principal sum” (Isaacs J. in *Munro* (1926) 38 C.L.R. 153 at 198), is a matter of subjective purpose, and that the general principle in regard to deductibility—that it is the objective purpose that governs ([6.2]–[6.16] above)—is subject to an exception in
this context. The investigation of subjective purpose in *Total Holdings* influenced Sheppard J. in *Magna Alloys & Research Pty Ltd* (1980) 80 A.T.C. 4542 to take a subjective approach to the determination of purpose in a context other than the deductibility of interest. It has been seen that the subjective approach in the context of the facts in *Magna Alloys* was rejected, albeit in a somewhat equivocal way, in the Federal Court. *Magna Alloys* is referred to in the Federal Court in *Ure* (1981) 81 A.T.C. 4100 as requiring an objective approach where the question is the purpose of outgoings by way of interest (per Brennan J. at 4104). But Lockhart J. in *Total Holdings* is not expressly rejected.

6.106 In *Total Holdings (Australia) Pty Ltd* (1979) 79 A.T.C. 4279 at 4286, Lockhart J. held that the activities of the taxpayer “were designed to render TAL profitable as soon as commercially feasible and to promote the generation of income by TAL and its subsequent derivation by the taxpayer and thence [the French holding company]”. He rejected any inference that “it was the dominant or, for that matter, any purpose of the taxpayer in making interest free loans to TAL that once TAL became profitable, a substantial portion of the shares held by the taxpayer in TAL would be disposed of to some outsider for capital profit”. He went on to assert that “even if the evidence did warrant the drawing of [the] inference [of purpose to make a capital gain], I am far from satisfied that it would operate to deny a business or income producing character to the interest-free loans over such a long period of time”. No reasons for this want of satisfaction are given, except in the reference to “a long period of time”. There must be circumstances where lending interest free to a company in which one holds shares, or, equally, subscribing for shares, reflects a purpose, not to derive income, but to generate a capital gain. It is not easy to appreciate why the Commissioner in *Total Holdings* made the admission he did in regard to the subscription for shares, while making the argument that there was no income producing purpose in the lending interest free. To the extent that a purpose to obtain a capital gain is to be inferred, the payments of interest should be denied deduction.

6.107 There will be other circumstances in which the inference must be that moneys were outlaid in acquiring shares, or in lending interest free to a company in which shares were held, for a purpose of obtaining a profit on the sale of the shares, whether in a business of dealing in shares or in a casual profit situation covered by s. 25A(1) (formerly s. 26(a)) or s. 26AAA. In these circumstances, too, there may be at least a partial denial of a current deduction of interest on money borrowed to acquire the shares, or to lend interest free. Where the taxpayer is a share trader the interest may be seen at least in part as a cost of trading stock, formally deductible
but subject to deferral until the shares are sold by the operation of s. 28. Where the situation is covered by s. 25A(1) or s. 26AAA or an ordinary usage isolated business venture principle, the interest may be, at least in part, a cost in computing the profit on realisation that will be income, or if there is a loss, that is deductible as a loss. Issues of tax accounting are raised that are more closely considered in Chapters 12 and 14 below.

6.108 Deductibility of interest depends on the payments having been made for the purpose of servicing the borrowing on which the interest is paid, and on the moneys borrowed having been laid out by the taxpayer for the purpose of the derivation of income. The blinkers approach may apply in limiting the facts that may be considered in determining whether the purpose of the payments is to service the borrowing, so that one may not look beyond the terms of the contract of borrowing. Total Holdings would appear to have rejected the blinkers approach so far as it might have limited the facts that may be considered in determining whether the moneys borrowed are laid out for the purpose of deriving income. It seems that one may look beyond the terms of a contract by which the moneys are on-lent. The blinkers approach, if applied in Total Holdings in relation to the on-lending, would have required a conclusion that interest paid on the moneys on-lent without interest was not deductible. A contract of loan at no interest does not show any purpose of laying out to derive income.

6.109 Two aspects of the decision in Ure (1981) 81 A.T.C. 4100 have already been adverted to. The case may be seen as some authority that in determining the purpose of the on-lending of money borrowed—which will “accessorially” determine deductibility of interest on the money borrowed if it was borrowed for that purpose—an objective approach is to be taken. Brennan J. said (at 4104): “The purposes for which money is laid out is an issue of fact, turning upon the objective circumstances which human experience would judge to be relevant to the issue (cf. Magna Alloys and Research Pty Ltd (1980) 80 A.T.C. 4542 at 4549).” There is, however, no such adoption of an objective approach in the judgment of Deane and Sheppard JJ.

6.110 And the case is authority that in reaching a conclusion as to the purpose of the on-lending the blinkers approach has no application. Lee J., at first instance, thought the principle, as expressed in Cecil Bros Pty Ltd (1964) 111 C.L.R. 430, Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2) (1976) 76 A.T.C. 6001 and South Australian Battery Makers Pty Ltd (1978) 140 C.L.R. 645 did apply, but was able to call on the qualification adopted by Gibbs A.C.J. in South Australian Battery Makers, which allows an examination of the facts beyond the contract to the extent that they show a benefit to the taxpayer other than that stipulated in the contract. Brennan
J. in the Federal Court simply failed to make any reference to *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers*, and assumed that in determining the purpose of the on-lending a broad inquiry was appropriate. Deane and Sheppard JJ. did advert to *Cecil* and *South Australian Battery Makers*, but the references made to those cases did not direct attention to the blinkers approach. Words are quoted (at 4109) from the judgment of Gibbs A.C.J. in *South Australian Battery Makers* that the characterisation of an outgoing will ordinarily be determined by reference to “the advantage which the expenditure was intended to gain, directly or indirectly, for the taxpayer”. The application of the Gibbs A.C.J. view of advantages relevant to the determination of the purpose of the outlay of the borrowed moneys in *Ure*, would have excluded as irrelevant any advantages conferred on others. Yet Deane and Sheppard JJ. found that among the objects of the outlay of the borrowed moneys were included “the financial benefit of the taxpayer's wife and a family trust” (at 4110), and that these objects justified denying some part of the deduction of interest on the money borrowed. The judgment of Gibbs A.C.J. in *South Australian Battery Makers*, if held applicable in determining the purpose of the outlay, and thus, accessorially, the purpose of the payment of interest, is inconsistent with the judgments in *Ure*.

6.111 The possible application of the blinkers approach in finding that aspect of the purpose of payment of interest that bears on deductibility, but is not concerned with the outlay of the moneys borrowed, was not an issue in *Ure* or in *Total*. This aspect is concerned with purpose to service—to maintain—the borrowing. A payment of interest at a rate beyond any commercial rate, more especially when made to an associated person, raises the question whether an inference should be drawn that some part of the purpose of the payment of interest is other than the service of the loan and, in this part, not relevant but private or domestic, or not a working or maintenance expense but a capital expense. On this question it may be difficult to distinguish and escape the authority of *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers*. There is reference in the judgment of Deane and Sheppard JJ. in *Ure* (1981) 81 A.T.C. 4100 at 4110 to *Cecil* and *Phillips* (1977) 77 A.T.C. 4169 as support for the proposition that:

“Where the immediate object achieved by the outgoing is the production of assessable income which is commensurate with the amount of the outgoing or where it is clear that the outgoing was for the purchase of stock-in-trade or the acquisition of services or hire of equipment used in earning assessable income, indirect objects or motives of a personal or domestic character will plainly not prevent the characterisation of the outgoing as having been incurred in earning assessable income.”
An explanation of *Cecil* in this way avoids treating the case as an application of the blinkers approach. But it is not the explanation of the case adopted in *Europa Oil (No. 2)* and *South Australian Battery Makers*. And the authority of the later cases can hardly be extinguished, at least by the Federal Court, by ignoring them, however much they might deserve to be extinguished.

6.112 *Ure* contains a statement of a rule to determine the deductibility of interest, in the judgment of Brennan J., thus (at 4104):

> “An outgoing of interest may be incidental and relevant to the gaining of assessable income where the borrowed money is laid out for the purpose of gaining that income (*F.C. of T. v. Munro* (1926) 38 C.L.R. 153 at 170, 171, 197; *Texas Co. (Australia) Ltd v. F.C. of T.* (1940) 63 C.L.R. 382 at 468). The laying out of the borrowed money for the purpose of gaining assessable income furnishes the required connection between the interest paid upon it by the taxpayer and the income derived by him from its use.”

It will be noted that the rule employs the word “interest”, and not some description such as “a payment to service a loan of money”. It thus offers the greater prospect of an extended form approach, which might lead to a payment being deductible if it is within the meaning of the word “interest” as a term of legal art, notwithstanding that the payment can be shown to have other purposes than the servicing of the borrowing, and notwithstanding that the payment is one, as in *Ilbery* (1981) 81 A.T.C. 4661, that secures a lasting benefit and is thus not a maintenance, but a capital expense. It will also be noted that the words used are “is laid out” for the purpose of gaining that income, though in the next paragraph of his judgment, Brennan J. reverts to language that is closer to the language of *Munro* when he says that the rule requires an “examination of the purposes for which the money was laid out”. It has been suggested above that any rule should be formulated in terms of the purpose for which the moneys borrowed are laid out at the time that interest is claimed to be deductible. There may not, however, be judicial support for such a formulation: Mason J. in *Handley* (1981) 148 C.L.R. 182 at 195, was not ready to give it support.

6.113 There is very little attempt in the judgment of Deane and Sheppard JJ. in *Ure* to formulate any rule beyond insisting on the significance of the purposes “which the application and use of the borrowed money were intended to gain” (at 4109–4110). They were, however, aware of the problems raised by any attempt to formulate a rule: “Where there is a difference between intended and actual use of the borrowed money or a change in use, difficulties may arise in determining what are the relevant objects or advantages which the payment of interest was calculated to procure. These problems do not arise in the present case however for the reason that there is neither suggestion that there was any difference between the proposed and the actual use of the borrowed money or between the objects or advantages which the borrowed money was intended to achieve and those which it in fact achieved nor suggestion that there was ever any relevant change in the use of the borrowed money” (at 4110). There is some discussion of the problems thus left unresolved, in
In all the judgments in *Ure* (1981) 81 A.T.C. 4100 there is discussion of the relevance of the use made of the money by the persons to whom it had been on-lent. Brennan J. said (at 4104): “where a question arises as to the purpose for which money is laid out by a taxpayer, it is erroneous to exclude as irrelevant evidence of the use of that money, albeit by others, in conformity with arrangements made by the taxpayer.” Where the moneys are on-lent at a commercial rate of interest a purpose to produce income is sufficiently established, without looking to the way in which the borrower under the on-lending has used the money. Where, however, the on-lending is at less than a commercial rate, the purpose to produce income may be inferred, for example, from the expectation of the taxpayer that the moneys will be used by the borrower from him to generate profits which will be distributed to the taxpayer and received by him as income. This was the way in which an income derivation purpose was found for the on-lending in *Total Holdings (Australia) Pty Ltd* (1979) 79 A.T.C. 4279. Where the use for the money which the taxpayer might have anticipated cannot involve any derivation of assessable income by the taxpayer, the circumstances are those in *Ure*. The taxpayer's purpose in on-lending included the derivation of interest at 1 per cent but that did not wholly explain his actions. It is not a matter of attributing to the taxpayer the purposes of the borrower from him. Those purposes are relevant only so far as they might suggest that the taxpayer has on-lent for the purpose of putting others in funds and not simply as a step which satisfies a condition precedent to his right to interest on the money on-lent. It is appropriate to say that he has used the money he borrowed for two distinct purposes—to obtain interest and to put the borrower in funds. So far as he has acted to put the borrower from him in funds, deduction of the interest paid by the taxpayer depends on whether the use of the funds by the borrower from him may be expected to result in the derivation of assessable income by the taxpayer.

The analysis in the last paragraph has a bearing on the operation of s. 67, a section applied by the Federal Court to give the taxpayer a full deduction of guarantee fees and legal expenses and valuation fees associated with his borrowing, albeit a deduction spread over the period of the loan. That a full deduction was allowed when only a small part of the interest expense was held deductible under s. 51 should provoke some questioning of the court's interpretations of s. 67. All members of the court thought the words of s. 67 which refer to “money used by [the taxpayer] for the purpose of producing assessable income” were satisfied by the circumstances that the taxpayer had on-lent to associated persons at 1 per
cent interest. And, indeed, all members of the court thought that the only use of the money made by the taxpayer was a use to produce the 1 per cent interest: other use of the money was use by the borrower from him. Once it was agreed that the taxpayer had outlaid money for purposes other than the derivation of the 1 per cent interest it should have followed that he had used money for purposes other than the derivation of the 1 per cent interest. If it is said that one does not use by giving something to another to use, then there is no use in any lending to another. The lending cannot become use simply because there is a reward for the lending. The reward does no more than satisfy a requirement that the use must be to produce income: it does not convert non-use into use. In 1984, subs. (4) was added to s. 67, so that the section now includes an express provision applicable to circumstances where the money borrowed is used by the taxpayer only partly for the purpose of producing assessable income. The taxpayer is deemed to have incurred only so much of the expenditure as, in the opinion of the Commissioner, is reasonable in the circumstances. If the reasoning of the Federal Court in *Ure* is to be accepted as correct, there will be no operation of s. 67(4) in the circumstances of *Ure*, to give the Commissioner power to deny deduction of some of the expenses of borrowing. It is a condition precedent to the Commissioner's power that the money borrowed has been used by the taxpayer only partly for the purpose of producing assessable income.

6.116 Section 67 is considered more closely later in this chapter. It is enough to say that the question it raises is raised by a number of other specific provisions of the Assessment Act allowing deductions where property is used for the purpose of producing income. Thus, s. 72 which relates to a deduction for rates and land tax, expressly requires an apportionment so that only a part of the outgoing is deductible if the property is only partly used by the taxpayer to produce assessable income. But on the reasoning in *Ure*, if some rent is reserved, property let to a relative at less than a commercial rate will be held to have been wholly used by the taxpayer to produce assessable income.

6.117 The conclusion in *Ilbery* (1981) 81 A.T.C. 4661, at least so far as it denied a deduction for interest, referable to the use of the money borrowed beyond the year of income, was clearly right. But the principles which most clearly direct that conclusion are not stated in the case. A payment which would obtain for the taxpayer the use of money without interest for a period, and thereafter its use on payment of a reduced rate of interest, is a payment to secure a lasting advantage. The parallel with *Strick v. Regent Oil* [1966] A.C. 295 is compelling. The payment in *Ilbery* is indeed the more removed from any claim to working or maintenance character, by the
fact that the advantage obtained might come to be enjoyed in circumstances having no relation to any process of deriving income: the money borrowed might cease to be outlaid in any such process. In *Strick v. Regent Oil* [1966] A.C. 295 (discussed in [7.34]ff. below) the advantage obtained by the payment of the premium—the tying of a garage proprietor so that he would sell only the taxpayer's product—could only be enjoyed in a process of income derivation. It is true that a payment for an advantage of the kind obtained in *Strick v. Regent Oil* may be a working expense where the advantage enures for some lesser period than the period in that case: *B.P. Australia Ltd* (1965) 112 C.L.R. 386 indicates the limits on *Strick v. Regent Oil*. But in *Ilbery* the advantage that was obtained from the payment was to subsist for 30 years. And there was the added factor that the advantage was one that could be used in circumstances having no relation to any process of income derivation.

**6.118 Strick v. Regent Oil** did not achieve any mention in *Ilbery*. Nor was there any attempt in *Ilbery* to show a parallel between the advance payment of interest and the payment of a premium on an ordinary lease of property that might presently be used in a process of income derivation, but which might at any time cease to be so used. There is a reference to *B.P. Australia* (at (1981) 81 A.T.C. 4661 at 4669) but only as endorsing the statement by Dixon J. in *Sun Newspapers Ltd* (1938) 61 C.L.R. 337 at 363 explaining when an outgoing is of a capital nature. Toohey J. appeared to accept counsel's submission that the prepayment of interest could not be denied working character because the prepayment involved no acquisition of assets. Counsel had argued: “If you make a list of [the taxpayer's] assets on that day before and after the transaction there would be no change.” Accepting counsel's submission makes the statement by Dixon J. a rule to be applied in its terms rather than its substance and indeed reformulates it in terms of “assets” when the word used was “advantage”. In any event cases subsequent to *Sun Newspapers*, in particular *John Fairfax & Sons Pty Ltd* (1959) 101 C.L.R. 30, have accepted that a conclusion that an outgoing is not working is not precluded by the circumstances that no “asset” or, indeed “advantage” results from the outgoing. The matter is considered below in Chapter 7.

**6.119 There is another basis on which deduction should have been denied in Ilbery**, a basis which will exclude deduction of interest which relates to any period beyond the year of income. To the extent that the interest paid related to the use of money beyond the year of income, it was not shown to be relevant because it was not established, nor could it be established, that the money would continue to be outlaid in a process of derivation of assessable income. The taxpayer might at any time sell the house and use
the proceeds for private purposes. Ilbery was an individual, but the same inability to show relevance will affect a payment of interest in advance by a company taxpayer. A company might sell the house and use the proceeds to pay a dividend or to return capital to its shareholders, or to make a new investment in operations that will produce foreign source exempt income.

6.120 The reasoning in *Ilbery* both at first instance and in the Federal Court offers ritual repetition of general statements about s. 51(1), and then moves to the level of propositions which tend to lose contact with the subsection, and substitute rules which may reduce the analysis to exercises in extended form. The basis of the decision in the Federal Court, so far as it can be identified from the judgment of Toohey J., is the contemporaneity rule: “At the time of the prepayment of interest the taxpayer had not acquired any property from which he hoped to derive income. There was no relevant income-earning undertaking or business in existence” ((1981) 81 A.T.C. 4661 at 4668). It is true that any sovereignty of form expressed in the defeat of the taxpayer, is qualified by an immediately following observation to the effect that the absence of an existing process of income derivation “is not necessarily fatal”. Yet the impression remains that the taxpayer's claim to a deduction might have been much stronger had he arranged for his clerk to take the cheque for the money borrowed to the nearest office of the building society, and there deposit it for the taxpayer, before the taxpayer drew the cheque for the payment of interest in advance. In any case, the emphasis on want of contemporaneity might have been turned aside by a submission that called on a principle that a cheque is only conditional payment, and that completed payment by the clearing of the cheque in fact occurred after the deposit of the moneys borrowed had been made with the building society. Which indicates how a reliance on extended form may abandon whatever good sense s. 51(1) may express.

6.121 The trial judge in *Ilbery* had accepted three propositions put to him on behalf of the taxpayer. They were:

1. Interest on moneys which are borrowed for the purpose of acquiring an income-producing asset is deductible under s. 51(1).
2. A payment made in a relevant year of income for the purpose of reducing payments which would otherwise have to be made in later years of income, where those payments themselves would be deductible, is deductible in the year of payment.
3. A payment made in the relevant year of income for the purpose of reducing payments which would otherwise have to be made in later years of income is deductible in the year of payment notwithstanding that the payment is made voluntarily” ((1981) 81 A.T.C. 4661 at 4665).
Toohey J. did not expressly question the first proposition, but some observations in his judgment do reflect on the proposition as a correct explanation of s. 51(1). Thus he would not agree that interest will continue to be deductible notwithstanding that the money borrowed has ceased to be invested in an income-producing asset:

“The Commissioner did not contest the proposition that so long as the Galway St property was held for an income-producing purpose, interest paid on a loan to acquire that property was deductible under s. 51. But if, for instance, the taxpayer decided in later years to occupy the property himself, payments of interest made thereafter would not be deductible. Whether some apportionment would be required in respect of the first year of personal occupation is a matter that does not have to be resolved” ((1981) 81 A.T.C. 4661 at 4668).

And his selection of observations from the judgment of Brennan J. in *Ure* (1981) 81 A.T.C. 4100 may indicate a view that the purpose in borrowing is irrelevant if, through a movement of funds, it is possible to trace the moneys borrowed into some asset in which the moneys borrowed may be said to be laid out for the purpose of gaining of income (at 4667). Thereafter, however, he switches the focus of the analysis so as to concentrate on the purpose of paying the interest, as distinct from the purpose of laying out the money borrowed. He would indeed appear to have rejected the view of Isaacs J. in *Munro* ([6.97] above) that “the interest paid in respect of the loan follows accessorially the purpose of the principal sum” ((1926) 38 C.L.R. 153 at 198). His conclusion on purpose of the payment of interest was that “no purpose can be discussed” [quaere discerned] “here other than that of gaining a tax advantage”. In reaching this conclusion he adverted to the fact that “the taxpayer never tried to conceal that his object in paying five years' interest in one year was to obtain the tax advantages thought to flow from that course” (at 4668). Which may indicate that he rejected the view that seemed to have emerged from *Ure*, that purpose bearing on deductibility is to be determined objectively.

6.122 The second proposition, which is, presumably, drawn from *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290, is rejected by Toohey J. as not being a rule of universal validity. A payment in a relevant year for the purpose of reducing payments which would otherwise have to be made in later years when those payments would be deductible, may itself be deductible, but it is not necessarily deductible. There is no indication given of what may determine when such a payment will be deductible, and when it will not. One factor of importance will be the extent of the immunity from future payments which follows from the payment. At some point the payment should be taken to have secured a “lasting advantage” (Dixon J. in *Sun Newspapers Ltd* (1938) 61 C.L.R. 337 at 363) such that it will have a capital, not a working character.

6.123 Strangely, Toohey J. did not offer an obvious comment on the relevance of the second proposition. It is confined in its terms to a case where the future payments “themselves would be deductible”. No such
assumption could be made about the future payments of interest in Ilbery. Toohey J. had already asserted that they would not be deductible if the taxpayer came to occupy the property himself.

6.124 The translation of Nevill into a rule which beset the court at first instance and the Federal Court, is an illustration of the process by which rules explaining s. 51(1) have come to be created. The application of the rule by the trial judge illustrates the extension of a form approach to those rules. Nevill should be seen as no more than an application of the basic principles of s. 51(1). The application of those principles in somewhat different circumstances where, for example, the payment is to secure the retirement of a life-governing director, may require a different conclusion.

6.125 In Ilbery (1981) 81 A.T.C. 4661, Toohey J. offered no comment on the third proposition accepted by the trial judge. A rejection of that proposition, and the adoption of a principle as to when an outgoing is incurred, parallel with that adopted in Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314 as to when an item of income in advance is derived, would have been a significant contribution to the development of principle. There is support for such a principle in Alliance Holdings Ltd (1981) 81 A.T.C. 4637 and Australian Guarantee Corp. (1984) 84 A.T.C. 4024; 4642, though the principle is not as boldly acknowledged as it might have been. Each case involved a borrowing on terms that interest would be paid when the money borrowed was repaid at the end of a fixed period. The question that was raised was whether the undertaking, on the occasion of a borrowing, of a liability to pay interest at a future time can involve the arising of an outgoing by an accruals basis taxpayer. James Flood Pty Ltd (1953) 88 C.L.R. 492, even after Nilsen Development Laboratatories Pty Ltd (1981) 144 C.L.R. 616, might establish that it can, though regard will need to be had to the terms of the borrowing to determine whether in fact an outgoing has arisen. The words “arising” and “arisen” are intended to denote the incurring of an outgoing in all respects save the respect that will determine the time of the outgoing. The same words might be used in relation to the derivation in Arthur Murray at a time when amounts for dancing lessons had been actually received or become unconditionally receivable, though the lessons had not yet been given. Woodward J. in Alliance Holdings and, more forthrightly, Lee J. in Australian Guarantee Corp., answered this question in the affirmative, and then decided, as a threshold issue in each case, that an outgoing for interest had arisen at the time of the borrowing. A further issue, more especially recognised in the judgment of Lee J., was then considered and decided. This issue concerns the time of deductibility of the outgoing for interest—the time when the outgoing becomes fully incurred. Each judge held that the outgoing was
incurred progressively as the benefit of the use of the money was enjoyed by the taxpayer—proportionally then to the period of the loan that had run during the year of income. In this there was a recognition of the principle that an outgoing, otherwise incurred, will be incurred as the benefit obtained by the outgoing is consumed in a process of derivation of income by the taxpayer. The principle is explained by Lee J. as adopting an aspect of accruals accounting as understood in accounting practice. He saw Arthur Murray as adopting a like aspect of accruals accounting as understood in accounting practice. The decision of Lee J. was upheld by the Federal Court: (1984) 84 A.T.C. 4642. The reasons of the Federal Court follow those of Lee J.

6.126 There may be reason to question the conclusions in Alliance Holdings and Australian Guarantee Corp. that, the timing aspect aside, an outgoing for interest had been incurred at the time of the borrowing, though references in James Flood to the possibility that an outgoing that is defeasible may yet be incurred may be thought to lend some support. The liability to pay interest in Australian Guarantee Corp. was defeasible to the extent that the lender might in some events ask for repayment of his loan and would then not be entitled to interest from the date he received repayment. If interest were held deductible in the circumstances of Australian Guarantee at the time of the borrowing there would be need of a principle by which the borrower would derive assessable income when the lender received early repayment. Such a principle would need to bring in as assessable income the amount of interest that would never become payable by the borrower. Which may indicate the wisdom of a principle that would spread the deduction of interest over the period of the borrowing. Deduction may then be denied from the time interest ceases to “accrue”. The matter is further considered in [11.73]ff. below. But the principle in regard to timing is a distinct principle, and one that is supported in this Volume as a general principle.

6.127 Northrop and Sheppard JJ. in Ilbery (1981) 81 A.T.C. 4661 agreed with Toohey J. and added a reason that if the outgoing had been otherwise allowable under s. 51(1) it would have been denied deduction by force of the principle in Ramsay v. I.R.C. [1982] A.C. 300. Ramsay and later United Kingdom cases have worked a significant limitation on the doctrine of form as it applies in the United Kingdom. At its broadest, the limitation directs that one ignore the tax consequences of the legal forms adopted by the taxpayer in a series of transactions, even though those consequences are directed by the statute when the statute is applied severally to each individual transaction. They may be ignored where the individual transactions are aspects of “a closely integrated situation”, and the tax
consequences determined by reference to the end result of all the transactions. Ramsay was concerned with a series of transactions involving gains and losses. One of these gains was claimed to be exempt. An individual transaction approach would have left the taxpayer with a tax loss. An overall approach would involve neither gain nor loss. Whatever may have been the appropriateness of the Ramsay approach to the operation of provisions imposing the United Kingdom capital gains tax, it is an approach that should be applied, not as reflecting a distinct principle imported from the United Kingdom authorities, but as the correct approach, in the application of broad principles in the Assessment Act—those principles that make up the notion of income by ordinary usage, and the principles to be drawn from s. 51(1). Stripped of the flourishes which express it in terms of “fiscal nullity”, the Ramsay approach is the approach of Dixon J. in Hallstroms Pty Ltd (1946) 72 C.L.R. 634 at 648: “What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.” The principle in Australian Guarantee Corp. (1984) 84 A.T.C. 4642, it might be noted, reflects a practical and business point of view. To this extent, the rejection of the authority of Ramsay and subsequent cases, in Oakey Abattoir Pty Ltd (1984) 84 A.T.C. 4718 is not significant. The dictum of Dixon J. would justify the analysis adopted by Derrington J. in Alloyweld Pty Ltd (1984) 84 A.T.C. 4328 in holding, in an Ilbery type situation, that the prepayment of interest was, from what he might have described as a “practical and business point of view”, a repayment of part of the money borrowed. Curiously, Alloyweld does not refer to the Federal Court decision in Ilbery.

6.128 The applicability of an Australian Guarantee Corp. principle to the facts of Ilbery (1981) 81 A.T.C. 4661 is perhaps a remote possibility. It would be assumed that the character of the payment as a relevant and working expense is to be determined at the time an outgoing “arises” in the sense of the word used in [6.125] above. The income character of an item otherwise derived in the circumstances of Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314 will be judged at the time it arises, though derivation is deferred by the Arthur Murray principle. The deductibility of an outgoing otherwise incurred in the Australian Guarantee circumstances will be judged at the time it arises, though incurring is deferred. The latter proposition may need some qualification to accommodate the possibility that events in the year of incurring may assist a conclusion that the outgoing is relevant, so that an outgoing which could not be shown to be relevant at the
time of arising may be shown to be relevant at the time of incurring. The need for such assistance is illustrated by the discussion of the Ilbery circumstances in [6.119] above. Judged at the time of arising, the outgoing in Ilbery was an outgoing to secure an “enduring advantage” and it could not qualify as a working expense. Immunity, complete or partial, from the payment of interest resulting from the payment in advance would extend over 30 years. Whatever assistance the circumstances at the moment of incurring may give on the issue of relevance, they do not assist on the issue of working character. To allow them a bearing on that issue would be to defeat the most fundamental distinction drawn in relation to deductibility, and to set at nought a number of provisions of the Assessment Act, more especially the depreciation provisions in ss 54ff. directed to allowing deductions in respect of certain capital expenses spread over the period of consumption of the benefits arising from those expenses. It is true that no provisions of the Assessment Act will enable the spreading and the allowance of deductions of a capital expense for interest in advance over the period of the borrowing, while the money borrowed continues to be used in a process of income derivation. But this is a deficiency of the Assessment Act common to a number of kinds of capital expenses.

6.129 B.P. Australia Ltd (1965) 112 C.L.R. 386 is authority that where an asset is acquired that will waste over a relatively short term of use in a process of income derivation, it is proper to treat the expense as an outgoing incurred and allow a deduction forthwith. It may be thought unfortunate that a principle that an expense is not incurred until it is consumed was not established in B.P. Australia. The allowing of an immediate deduction was not questioned in the case. The case is however only authority that an immediate deduction may be allowed when the advantage will endure over a relatively short term. It ought not to be seen as inconsistent with the Australian Guarantee principle.

6.130 Strick v. Regent Oil Ltd [1966] A.C. 295 is authority that where the asset will waste over a relatively long term, the expense must be seen as securing a “lasting advantage”, in the sense of those words in the formulation of principle by Dixon J. in Sun Newspapers Ltd (1938) 61 C.L.R. 337 at 363, and be denied deduction as capital. Any deduction in respect of the expense must depend on the availability of specific amortisation or depreciation provisions in the Act. There were none such applicable in the circumstances of Strick v. Regent Oil. There are none such applicable in the circumstances of an expense to secure an immunity from an obligation to pay interest.

6.131 It is implicit in the analysis in the preceding paragraphs that any rule framed in terms of the deductibility of “interest” must always be an
unsatisfactory expression of the principles expressed in s. 51(1). The true issues of principle posed by Ilbery (1981) 81 A.T.C. 4661 are simply obscured by any debate as to whether the payment by the taxpayer was correctly described as a payment of interest. Such a debate would only be relevant if, in the circumstances, some specific provisions, for example those relating to withholding tax, attach consequences in terms to a payment of “interest”.

6.132 If the issue is income quality in the hands of the finance company receiving the payment in the circumstances of Ilbery, the question whether the receipt is interest is equally irrelevant, though it may be relevant if the company is a private company and the issue is the amount of the retention allowable available to that company: the specific provisions of s. 105B, and the definitions of “income from property”, and “income from personal exertion”, are attracted, and the latter definition refers to “interest” in the excluding parts of the definition.

6.133 Consideration was given in [2.285]-[2.289] above to the questions of whether an amount is income of the lender, if it is the amount of a discount allowed by a borrower who has acknowledged indebtedness of an amount greater than the amount he has received, and whether an amount is income of the lender if he receives a premium on the repayment by the borrower of a loan. The solution to these questions does not depend on whether the discount or premium is “interest”, though again a characterisation as interest may be relevant to the operation of specific provisions such as those imposing withholding tax. The discount or premium could be income as a gain from the carrying on of a business by a person engaged in the business of money lending (Proposition 14), or be income derived from property (Proposition 12), whether or not the person deriving the discount or premium is in business. It is not easy to see how it could be income of the latter kind where it is not received by the person who initially entered into the transaction which gave rise to the loan which is repaid—the initial lender may have sold the debt to the person who receives payment. These matters are further considered in [11.252]-[11.267] below.

6.134 There are problems of deductibility by the borrower of the amount of discount allowed—in effect the further amount beyond what he received that is payable on repayment—or the amount of the premium paid on repayment. These problems, like those relating to income character, do not depend for their answer on whether the discount or premium is “interest”. The general principle in the case of a borrower who borrows for business purposes, is that the greater amount necessary to discharge a liability on revenue account than the amount received, is a loss incurred in carrying on his business. There may be problems in resolving the issue whether the
borrowing is on revenue account, problems explored in [6.322]-[6.330] and
[12.192]ff. below in relation to exchange gains and losses. Where the
borrowing is not on revenue account or the borrower is an investor who
does not have a business, deductibility depends on whether the amount of
the discount reflected in the greater amount paid on repayment, or the
premium, is a working expense as an expense of servicing or maintaining
the borrowing. There is in each case a payment which is an outgoing, and,
assuming a use of the money borrowed in a process of income derivation
so that the necessary connection with income derivation is established, the
payment may be characterised as working, unless it relates to a period of
borrowing that amounts to an enduring advantage.

6.135 If the view is taken that the principle in *Australian Guarantee Corp.*
(1984) 84 A.T.C. 4642 is applicable to a discount allowed, the amount of
the discount could be deductible over the period of the borrowing. There
would, however, be difficulty where the taxpayer is on a cash basis of
returns in relation to the item, if it is insisted that deductibility in the case
of a taxpayer on a cash basis requires that there should have been an actual
cash outlay. The principle in *Australian Guarantee* may defer the incurring
of an outgoing, it cannot advance the incurring.

6.136 If the principle in *Australian Guarantee* is held applicable to a
discount allowed, the spreading of the discount over the period of the
borrowing should be available to a taxpayer who would in any event be
entitled to a loss deduction on discharge of the liability, the liability being
on revenue account. Deduction of both the outgoing deduction and the loss
deduction is precluded by s. 82.

6.137 It is a fair comment that the cases on the operation of s. 51(1) in
relation to the deductibility of interest leave the interpretation of the
subsection in considerable chaos. One thing may be clear: borrowing for
the purpose of outlaying the money borrowed in a business or in acquiring
property whence assessable income will be derived will not be enough to
make interest on the money borrowed deductible. There must be an actual
outlay. But the link between the borrowing and the outlay is left largely
unexplored. If an objective inference can be drawn that the borrowing was
made for the purpose of having money which would be laid out for the
purpose of gaining income in some process of income derivation, and
money is so laid out, a link—referred to above as a tracing through
purposes—is established which may be sufficient. The possibility remains,
however, that in addition to a tracing through purposes, a link established
by a tracing through a movement of funds is necessary. The cases offer no
assistance on the method of tracing through movement of funds that may
be necessary. Tracing where moneys are co-mingled in a bank account will
require the settling of a rule that may provide for an apportionment, or may adopt the rule in *Clayton*’s case (1816) 1 Mer. 572; 35 E.R. 781, or, perhaps, a rule of last-in-first-out.

6.138 There is no indication in the cases that a tracing through a movement of funds is in itself sufficient. We do not know whether interest on moneys borrowed for some private purpose becomes deductible when the moneys borrowed can in fact be traced by movement of funds into an outlay which for the time being is for the purpose of gaining assessable income. It would be generally assumed that interest on moneys borrowed to acquire a house to be used for private purposes, becomes deductible when the private use ceases and the house is let for the purpose of gaining rental income. But there is no judicial statement supporting that assumption. There is a statement, in the judgment of Toohey J. in *Ilbery* (1981) 81 A.T.C. 4661, that interest on moneys borrowed to acquire a home to be let for the purpose of gaining rental income, ceases to be deductible when the house ceases to be let so that the money is no longer laid out for the purpose of gaining income. And this would accord with the general assumption. But there is no judicial statement that would support another assumption that would be generally made, that interest on moneys borrowed for the purpose of an outlay in a process of income derivation remains deductible if there is a change in outlay which can be traced through a movement of funds, provided the new outlay is for the purpose of gaining income, and this is the case whether or not the new outlay can be said to be within the purpose of the borrowing.

6.139 What will qualify as an outlay for the purpose of gaining income remains very largely unexplored. *Total Holdings (Australia) Pty Ltd* (1979) 79 A.T.C. 4279 is authority that a purpose of an indirect gaining of income may be sufficient. Lending by a taxpayer to a company interest free may be an outlay to gain income in the form of dividends on shares held by the taxpayer in the company. The outlay of equipment held on lease by the taxpayer in *Marr & Sons (Sales) Ltd* (1984) 84 A.T.C. 4580, by allowing its use by subsidiary companies might have been regarded as an outlay for the purpose of gaining income in the form of dividends, so as to justify the deduction of the rental payments made by the taxpayer. It is the gaining of income by the taxpayer that is relevant. An outlay of borrowed money for the purpose of enabling a company with which the taxpayer is associated to gain income, will not in itself make interest paid on the borrowing deductible. *Total Holdings* is not inconsistent with a conclusion that a purpose of on-lending money to a company in which the taxpayer is a shareholder, or of acquisition of property by a taxpayer with borrowed money, is to obtain a non-income gain that will be derived on a realisation
of the shares or of the property acquired, with the consequence that some part of the interest paid on the borrowed money may be denied deduction under s. 51(1). That conclusion is the more likely if the current income from the shares or property is significantly less than the interest paid on the borrowed money.

6.140 The notion of income in a rule that seeks to express s. 51(1) in terms of an outlay of borrowed money for the purpose of gaining assessable income calls for examination. A taxpayer may borrow money to invest in a superannuation scheme to which Div. 9B of Pt III applies. A purpose to provide money which will be invested by the scheme so that the scheme derives income, is clearly not a purpose that can give deductibility to interest on the money borrowed. The taxpayer may derive income from the scheme on his retirement which is at least in part his assessable income. But the money borrowed is not outlaid for the purpose of gaining income in any sense that will express s. 51(1). The interest paid on the borrowing is a cost of the pension that is income or of the lump sum that is income. In any case the pension received from the fund in any year will be assessable income only in the amount of the balance after the subtraction of the appropriate part of the “undeducted purchase price” under s. 27H ([2.215] ff. above). Unless the unacceptable inference from the words added to s. 25 (1) in 1984 is insisted on ([4.5] above), the amount of the pension absorbed by the subtraction, will not be income, and the outlay of the borrowed moneys by investment in the superannuation scheme could be as well said to be for the purpose of gaining this non-income receipt, as it may be said to be for the purpose of gaining the assessable income receipt.

6.141 Where a taxpayer borrows money to buy an annuity for a fixed term of years, he does not outlay the borrowed money to gain income in the sense of those words in any rule that seeks correctly to express s. 51(1). And the additional argument made in the last paragraph arising out of the operation of s. 27H is equally applicable here. There is another reason why the interest on the borrowed money should not be held deductible over the period of the annuity. A fixed term annuity is, commercially, a return of the amount paid for the annuity, spread over the term, with an element of interest in respect of any amount still awaiting return. It follows that the amount borrowed that remains laid out in the investment in the annuity declines each year. Unless purpose on the initial investment is the only concern of the rule—and there is authority in the judgment of Toohey J. in *Ilbery* that it is not—the amount of interest that is deductible must decline each year.

Rent
6.142 The deductibility of rent that relates to property which is used in business, or to property whence income is derived, involves questions which for the most part parallel those raised in regard to interest. In general, the questions are simpler to resolve. Problems of tracing through movement of funds are not raised. The relationship between the payment of rent and the use of the property to produce income will be manifest in most circumstances. In *Marr & Sons (Sales) Ltd* (1984) 84 A.T.C. 4580 the payments of rent related to leased plant which the taxpayer allowed its subsidiary companies to use in their business operations. One would have thought that, on the authority of *Total Holdings*, there was an outlay of the plant to produce income, in the form of dividends on the shares in the subsidiaries held by the taxpayer. The Federal Court did not need to reach a conclusion, as it in fact, that the taxpayer was engaged in a business of leasing plant from others and making it available to its subsidiaries.

6.143 But some questions are not less difficult of resolution. Where payment of rent is made to an associated person, or where it is paid in circumstances such as *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645, the question is raised whether a doctrine of extended form, and a blinkers approach, are applicable. If the property is on-let to another at less than a commercial rent, the questions raised and discussed above in dealing with *Ure* (1981) 81 A.T.C. 4100 are raised.

6.144 There are questions as to how any rule of relationship between the payment of rent and the use of the property in a process of income derivation is to be framed. It will be recalled that there are some formulations of a rule in regard to interest that would require that the money should have been borrowed for the purpose of use in the business or in the investment whence income is derived. It would follow that no deduction will be available for rent if a lease is taken of property that is used for a time for private purposes, and thereafter used in a business, or thereafter let to another. And there are questions as to what may follow if a lease of property has been taken for use for business purposes or for on-letting, and thereafter the property ceases to be so used. It would be generally assumed that the rent paid is deductible if it relates to property presently used in a process of income derivation, and that the original purpose in taking the lease under which the rent is paid is irrelevant. The assumption has a bearing on what should ultimately emerge from the cases beginning with *Munro* (1926) 38 C.L.R. 153 as to the deductibility of interest.

6.145 The use of the word “rent” in these observations is convenient but the obvious comment must be made that there is no statutory provision by which “rent” is made, in terms, deductible. The governing provision is
again s. 51(1) and, granted that the payment is relevant, the deductibility of a payment called “rent” will depend on whether it has a working or maintenance character.

6.146 Where a payment is made on the obtaining of a lease of property, it will generally be called a “premium”. The Act has dealt, partially, in s. 26AB, with the question of the income character of a premium as defined in the section, received by a lessor or an assignor of a lease, but that section does not deal with deductibility of such a premium. As explained in [2.306]–[2.308] above, the assumption in s. 26AB is that a premium paid, though it relates to property used in a process of income derivation, is not deductible. A premium was denied deduction in the United Kingdom in Strick v. Regent Oil Ltd [1966] A.C. 295 and there is some prospect that a judge-made rule and an extended form approach, will deny deduction generally.

6.147 The problems in regard to deductibility under s. 51(1) of a premium and of rent in advance, are parallel with those that arise in regard to an advance payment of interest on a debt, problems which have been canvassed earlier in this Volume. If the premium or rent in advance is treated as incurred at the time of payment, it may be regarded as not a working but capital expense. And there is an argument to be made that the outgoing cannot be shown to be relevant to the derivation of income so far as it relates to the use of the property beyond the year of income.

6.148 If, however, the principle is accepted that an outgoing is not incurred until it is consumed, it is possible to treat a premium or rent in advance as incurred over the period of the lease to which it relates. The principle may assist in the showing of relevance, but it will not assist in overcoming a characterisation of the payment as a capital outgoing, because it gives rise to an enduring advantage.

Rates and repairs

6.149 The deductibility of rates and repairs that relate to property which is an asset of a business or to property whence income is derived, like the deductibility of rent, involves questions which for the most part parallel those raised in regard to interest. Attention is directed to the discussion of the deductibility of interest and rent.

6.150 Deductibility of rates and repairs involve special factors. There are specific provisions of the Act, in ss 72 and 53, governing the deductibility of rates and repairs, and there is a question of the effect of those specific provisions on deductibility under s. 51(1). There is a further special factor in regard to repairs. A taxpayer who effects repairs may be the owner of
the property or he may have rented the property from another. If he has rented the property from another, there is a question whether the notion of working or maintenance expense may have a scope different from its scope where repairs are effected by an owner.

6.151 Section 72 allows a deduction of sums for which the taxpayer is personally liable which are paid in Australia by him in the year of income for (a) rates which are annually assessed, or (b) land tax imposed under any law of a State or of a Territory being part of Australia. The deduction is not allowable unless the amount is paid in respect of land that is, or premises that are, used by the taxpayer during the year of income for the purpose of gaining or producing income or carrying on a business for the purpose of gaining or producing income (s. 72(1B)). It will be noted that the words used parallel words in s. 51(1), with the difference that the word income is used unqualified by the word “assessable”. The section would thus appear to allow a deduction notwithstanding that the income gained or produced is exempt income. The section at one time allowed a deduction though there was no gaining or producing of income, assessable or exempt. The section, in this wide operation, had its origin in provisions of the Assessment Act which included an amount in a taxpayer's income, as imputed income, where he owned land and used it for private purposes. When the provisions in regard to imputed income were repealed the deduction section remained for a period unchanged. In 1973, s. 72 was amended to allow a deduction for rates and land tax in respect of land privately used, only when the amount was paid in respect of land used by the taxpayer during the year of income as his sole or principal residence. Commencing with the 1976 year of income, this deduction was denied and a concessional rebate, under s. 159V, substituted for it.

6.152 A more important question than the potential application of s. 72 in relation to exempt income, is the scope of the operation of s. 72(1C) where land is used by the taxpayer during the year of income “partly for the purpose of gaining or producing income and partly for another purpose”. In these circumstances “so much only of the amount paid is allowable as a deduction as, in the opinion of the Commissioner, is reasonable in the circumstances”. Where a distinct part of premises is used by the taxpayer in some process of income derivation, and the remainder is used by him for private purposes, s. 72(1C) will clearly be attracted. And it would appear to be attracted where the same premises are used by the taxpayer as a base of business operations and for private purposes or are used for part of the year for letting and for the remainder privately. There will however be a question as to the operation of s. 72(1C) if premises are let to an associated person at less than a commercial rental. In Ure (1981) 81 A.T.C. 4100 the
Federal Court, in the application of s. 51(1), allowed a deduction of only a part of interest paid on money borrowed that was in turn lent to associated persons at less than a commercial rate, on the ground that some of the purposes in the on-lending were not purposes to produce income.

At the same time the court concluded that the taxpayer was entitled under s. 67 to a deduction of the whole amount of valuation fees and legal costs he had incurred in association with the borrowing, on the ground that he had made only one use of the borrowed money and this was to re-lend it to the associated persons at 1 per cent interest. The notion of use thus adopted by the Court was the subject of some comment in [6.114]–[6.116] above. If the interpretation of s. 67 adopted by the Federal Court is applied to s. 72 where premises have been let to an associated person at less than a commercial rent, it may follow that the whole amount of rates paid in a year will be deductible under s. 72, notwithstanding that the conclusion in *Ure* as to the deductibility of interest on money borrowed and outlaid in acquiring the premises would require that only a partial deduction would be allowable under s. 51(1). It will be said, on the authority of *Ure*, that the conditions for the exercise of the discretion given to the Commissioner by s. 72(1C) are not met, and the Commissioner must allow a full deduction under s. 72(1B)(a). Section 82(1) would not appear to assist the Commissioner to deny the deduction in part by insisting that s. 51(1) is the more appropriate. That section would appear to deal only with circumstances where the same deduction is allowable under more than one section, whether in the same or different years of income, and gives the Commissioner a discretion as to which section is to be taken to allow the deduction. Section 82(1) would not, it is thought, enable the Commissioner to deny a full deduction of an amount deductible under s. 72 by asserting that s. 51(1) is the more appropriate and s. 51(1) will allow a deduction of only part of the amount.

In *Ure* the assumption of all members of the Federal Court was that no part of the valuation fees and legal costs were deductible under s. 51(1). They were not working or maintenance expenses of the borrowing: they were costs of obtaining the borrowed moneys. Section 67 was left to operate, with the curious interpretation given to it by the court, but without any competition from s. 51(1). The majority of the Federal Court thought that s. 67 applied also to the guarantee fees, and that s. 51(1) did not because they were not maintenance expenses. There was therefore no competition between the sections. Brennan J. (dissenting on this point) thought that s. 67 did not apply to the guarantee fees, but s. 51(1) did apply and an apportionment was proper under s. 51(1) that would follow the apportionment of the interest expense. Again there was no competition
between the sections.

6.155 Section 72 and its correlation with s. 51(1) are the subject of further consideration in [10.38]ff. below.

6.156 Section 53 deals specifically with “expenditure incurred by the taxpayer in the year of income for repairs, not being expenditure of a capital nature, to any premises, or part of premises, plant, machinery, implements, utensils, rolling stock, or articles held, occupied or used by him for the purpose of producing assessable income”. Since 1984, there is an express provision in the section applicable to circumstances where the property is held, occupied or used only partly to produce assessable income. The section has been the subject of extensive judicial interpretation, more closely considered in [10.8]–[10.26] below. The correlation between s. 53 and s. 51(1) has not however been the subject of any judicial decision. The Commissioner is empowered by s. 53(3), where the premises were held, occupied or used by the taxpayer only partly for the purpose of producing assessable income, to allow a deduction of only so much of the repair expenditure as he considers reasonable. There is a question whether the reasoning in *Ure* referred to in [6.115]–[6.116] will be applicable to deny the Commissioner such power in circumstances where the property has been let to an associated person at less than a commercial rental. If only s. 51(1) governed, he would, on the authority of *Ure*, be entitled to deny a deduction of some part of the expenditure because there would appear to be more than one purpose in the letting, and some of those purposes are not to derive income. But s. 53, following the Federal Court interpretation of s. 67, would allow a full deduction because there is no “holding” or “use” other than a holding or use to produce assessable income. If the view of s. 82(1) taken above ([6.153]) is followed, that section would not enable the Commissioner to insist on the s. 51(1) consequences against the s. 53 consequences.

6.157 In the context of repairs, s. 51(1) may have a wider operation than s. 53. It will be seen ([10.8]ff. below) that the word “repairs” in s. 53(1), and the phrase “not being expenditure of a capital nature”, have been interpreted in the cases without drawing any distinction between repairs by an owner of property who uses it to produce income, perhaps by letting it to another, and repairs by a lessee, who may repair in pursuance of a convenant to repair undertaken in his lease. There is no judicial decision that no such distinction should be drawn, though the assumption would appear to be that it should not. Section 51(1) may well admit of such a distinction being drawn, and of a conclusion that repairs which would not be working expenses if carried out by an owner may yet be working expenses if carried out by a lessee. An “improvement”, as that word has
been used in the cases involving s. 53, effected to premises, is not a working or maintenance expense if done by an owner. The improvement may involve an accretion to structure in the greater durability of the premises after the repair. But such an improvement may be a working or maintenance expense if done by a lessee in carrying out his obligations under his lease. The expense, looked at in the circumstances of the lessee, merely services the lease. It is no different from rent paid by the lessee. There may be room to say that an improvement is not a working expense, though carried out by a lessee, where the repair involves an improvement in function. The advantage of the improvement will be enjoyed by the lessee for the period of the lease, and it may be seen as involving an accretion to the lessee’s structure. But this reasoning would not be valid where there is an improvement only because of the element of greater durability.

6.158 Allowing a deduction by the lessee of the cost of improvements, when the like cost if the work had been done by the lessor would not be deductible by the lessor, raises prospects of tax planning suggested by experience with the operation of Div. 4 of Pt III prior to 1964. That Division allowed the lessee deductions in respect of the cost of certain structural improvements and made provision for the inclusion of amounts in the assessable income of the lessor. Tax planning schemes exploited those provisions, more especially where lessor and lessee were associated taxpayers. The schemes relied, in one aspect of them, on a disparity between the greater amount that was allowable to the lessee, and the lesser amount that was included in the assessable income of the lessor.  

6.159 The planning that will be possible if, as is suggested, the lessee may deduct the cost of some improvements under s. 51(1), will exploit the principle in *Tennant v. Smith* [1892] A.C. 150 discussed in [1.81]–[1.88] and [2.30]–[2.32] above. The realisable value of the improvements which are, it is submitted, income of the lessor as gains derived from property, may be much less than the cost to the lessee. It will be recalled that *Tennant v. Smith* has been displaced by s. 26(e) in the circumstances of rewards for services. *Cooke and Sherden* (1980) 80 A.T.C. 4140 has demonstrated the narrowness of s. 26(e) and the need to displace *Tennant v. Smith* in the context of business gains other than rewards for services. The tax planning now contemplated may indicate the need to displace the *Tennant v. Smith* principle in the context of gains derived from property.  

6.160 In the context of repairs, s. 51(1) may have a narrower operation than s. 53. *Ilbery* (1981) 81 A.T.C. 4661 may be taken as authority that the contemporaneity principle, as an aspect of s. 51(1), extends to servicing expenses of property used for the purpose of producing income. The
payment of interest in advance was an outgoing incurred before the money borrowed had been invested in an asset producing income. It would follow that an expense for repairs incurred at a time when the property has ceased to be used for the purpose of producing income would not be deductible. No contemporaneity requirement has been read into s. 53, though the words of s. 53(1) do not exclude it. The matter is more closely considered in [10.27]ff. below.

Interest, rent, rates and repairs where there is a charity letting of property

6.161 *Ure* (1981) 81 A.T.C. 4100, it will be recalled, broke the grip of the approach in terms of extended form and blinkers which had inhibited any sensible operation for s. 51(1) since *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430. Where money borrowed is on-lent at less than a commercial rate, it is possible to find a purpose of the on-lending and, accessorially, a purpose of the payment of interest on the money borrowed which may be a further purpose distinct from that of deriving interest income from the on-lending. It follows from *Ure* that where money borrowed has been invested in property which is let to another at less than a commercial rent, it is possible to find a purpose in the letting and, accessorially a purpose of the payment of the interest on the money borrowed, which may be a further purpose distinct from that of deriving rent from the letting of the property. It also follows from *Ure* that a similar analysis may be applied in relation to the purpose of payment of rent in respect of property which is in turn on-let to another at less than a commercial rental. A similar analysis may be applied in relation to the purpose of payment of rates and the costs of repairs in respect of such property.

6.162 An inference of a further purpose is not necessarily to be drawn. The property may have been already let at less than a current commercial rate at the time it was acquired by the taxpayer, and the taxpayer acquired subject to the existing tenancy. And an inference of a further purpose may not easily be drawn where the actual rent is not significantly less than a commercial rate, at least where the tenant is not an associate of the taxpayer lessor.

6.163 Where the letting is at a rental significantly less than a commercial rate, and an inference of further purpose is to be drawn, there is a possible conclusion that the apparent purpose to use the money borrowed or the property to which interest, rent, rates or repairs relate, in a process of income derivation is not such as will give an income quality to receipts arising from the use. In Chapter 2, [2.437]ff. above, attention was given to the notion of business in relation to Proposition 14, and to the profit
purpose which is an element of that notion. Where the conclusion is that the taxpayer has engaged only in a hobby, proceeds of his hobby will not be income and he will be denied deduction of any costs he has incurred. Though the matter was not pursued in relation to Proposition 12, it is arguable that there is no gain derived from property unless the taxpayer has sought a commercial return from his property. If the inference is that he has merely sought some contribution towards the expenses he must incur in relation to the property, the receipt of the contribution may not be his income, and the expenses he has incurred may not in any part be deductible: *Groser* (1982) 82 A.T.C. 4478, cf. *Kowal* (1984) 84 A.T.C. 4001.

6.164 So far as interest and rent paid are concerned, the end result of this analysis may not be significantly different from the end result of the *Ure* analysis. It will be recalled that in *Ure* the amount of interest deductible was limited to the amount of interest received on the on-lending. Where, however, the question concerns the deductibility of expenses in the forms of guarantee fees, legal expenses associated with a borrowing and valuation fees—the other expenses with which *Ure* was concerned—and s. 67 is otherwise applicable, or where the question concerns rates on and repairs to property and s. 72 or s. 53 is otherwise applicable, the analysis will produce different consequences from those held to follow in *Ure*. Far from a full deduction being allowable for the fees, rates and repairs, none will be deductible, since the condition of a purpose of gaining or producing income will not be satisfied.

6.165 Where money is borrowed and applied in acquiring property let at a commercial rate, or expenses are incurred for rent rates or repairs on a property let at a commercial rate, it may not be easy to reach a conclusion that some part of the interest on the money borrowed or some part of the expenses for rent, rates or repairs, was incurred for a purpose other than the derivation of assessable income. An objective inference may in some circumstances be drawn that the taxpayer's purpose in laying-out the borrowed money in the acquisition of the property, or in the holding of the property on which rent, rates or repair expenses have been paid, was to obtain a gain by realising the property. The circumstances that the interest rent rates and cost of repairs paid exceed the rent received may justify such an objective inference. The fact that current expenses exceed the current return from property is at least a factor which points to a conclusion, within the words of s. 25A(1) (formerly s. 26(a)), that property has been acquired for the purpose of profit-making by sale.

6.166 *Ure* has implications for the effectiveness of an income-splitting plan by which a husband owning property already leased will give a concurrent
lease—a lease of the reversion—to his wife at a modest rental. The assumption is that he will retain the deductibility of expenses by way of interest, rates and repairs, as outgoings in gaining the modest rental income derived from the property let in the concurrent lease. His wife will be entitled to a deduction of the rent paid to her husband and will derive income in the amount of the commercial rent under the lease first entered into by her husband.

6.167 The disparity between the rent under the first lease and the rent under the concurrent lease, and the relationship of husband and wife, are enough to support an objective inference that the purpose of the concurrent lease was, at least in part, not the derivation of income by the husband, but to enable the derivation of income by the wife. The husband's outgoings on interest, and, if the view of ss 72 and 53 taken in this Volume is correct, his outgoings on rates and repairs will be allowable deductions only in part. The outcome of the income-split will be unfavourable: the total tax payable by husband and wife may, indeed, be increased.

Sections 82KJ and 82KL, and Part IVA

6.168 The possibility of the application of extended form and blinkers approaches in the determination of the purpose of a payment of interest, rent, rates or for repairs, has been adverted to on occasions during the preceding discussion. Ure (1981) 81 A.T.C. 4100 is authority that form and blinkers have no application where the deductibility of interest depends on the purpose reflected in the application of the moneys borrowed. But the possibility cannot be excluded that extended form and blinkers approaches, qualified as they may be by South Australian Battery Makers Pty Ltd (1978) 140 C.L.R. 645, are applicable where it is asserted that the payment of interest, rent, rates or for repairs was not, or was not only, to service the holding of the money or other property involved in a process of income derivation.

6.169 In none of Munro (1926) 38 C.L.R. 153, Total Holdings (Australia) Pty Ltd (1979) 79 A.T.C. 4279, and Ure, however wide the circumstances that may properly be taken into consideration, could there be any conclusion drawn that the payment of interest had any purpose beyond the servicing of the money borrowed. The addition of facts of the kind that existed in Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2) (1976) 76 A.T.C. 6001, South Australian Battery Makers or Phillips (1978) 78 A.T.C. 4361 would however raise the possibility of a conclusion of another purpose, and the continuing authority of extended form and blinkers approaches would be fairly posed. The taxpayer in Ure, might, for example, have
borrowed from a family trust at a rate of interest in excess of a commercial rate. With effect from dates in 1978 and 1979, ss 82KJ and 82KL may operate to overcome extended form and blinkers approaches, and, to the extent that they do not, Pt IVA (Schemes to Reduce Income Tax) may apply where the scheme was entered into after 27 May 1981 or it is otherwise within the provisions of s. 177D defining the operation of the Part. Sections 82KJ and 82KL are further considered in [10.330]–[10.343] below and Pt IVA in Chapter 16 below.

6.170 An advance payment of interest of the kind in *Ilbery* (1981) 81 A.T.C. 4234, 81 A.T.C. 4661, if it were to occur now, would be deductible only if it could escape not only the authority of *Ilbery*, but also the operation of s. 82KL and Pt IVA.

### The Characterisation of Payments of Royalties

6.171 The discussion that follows concerns royalties in a broad meaning of the word, embracing payments in respect of rights to take something from land or to use land, payments in respect of monopoly rights attaching to items of commercial or industrial property, and payments in respect of the supply of know-how.

6.172 “Royalties” is defined in the Assessment Act, and the definition is relevant to what may be income by virtue of the specific provisions in s. 26 (f). It is also relevant to the operation of s. 6C, which may give an Australian source to items which are royalties within the definition. There is, however, no provision in the Assessment Act which, in terms, makes royalties deductible, whether royalties as defined or royalties in some other usage of the word. The present discussion is concerned with deductibility under s. 51(1). Some mention is also made of possible amortisation deductions under Div. 10 (General Mining) or Div. 10B (Industrial Property) and s. 124J (Timber on land).

6.173 In [2.309]ff. and [4.114]ff. above attention was given to the question of how far royalties in a broad meaning of the word are income of a person who receives payment of the royalties. An underlying notion that a receipt is income derived from property where it may be said to be a receipt for the use of that property by another, may explain the character of income given to a receipt. At times, however, the quality as a receipt for the use of property by another seems tenuous in an item held to be income. At other times the underlying notion is simply not present and some other quality giving the item its income character must be found. The quality may be periodicity of the receipt.

6.174 If the notion of receipt-for-the-use were always present and
definitive where a royalty is treated as income of a person receiving payment, there might be thought to be room for a principle that a royalty payment that is income of the payee is deductible by the payer, provided it is an expense that is relevant to the derivation of income by the payer. A notion of payment-for-the-use, when present, might be thought to give the character of working expense to a payment. But this will not always be so. A patented process may be used in the construction of plant by a taxpayer who does so under licence and makes a payment therefor. The payment is a cost of the plant and not a working expense.

6.175 Indeed, the principle is that deductibility of a payment must be judged in the circumstances of payment by the taxpayer who made the payment and claims the deduction. It is irrelevant, in itself, how the issue of deductibility would have been resolved if payment had been made by some other person. And it is in itself irrelevant how the question of income quality of the receipt in the hands of the payee is determined. In *B.P. Australia Ltd* (1965) 112 C.L.R. 386 the deductibility of the payments was determined without regard to whether the payments would be income in the hands of the payee. It follows that the observations made by Barwick C.J. in *Cliffs International Inc.* (1979) 142 C.L.R. 140 that the payments made by Cliffs to Howmet and Mt Enid were income in their hands, did not bear directly on the question of deductibility by Cliffs. The matter is considered in [6.22]–[6.26] above.

6.176 Which is not to say that the circumstances of receipt by another person have no bearing on the character of the payment by the payer. If the circumstances of a receipt give it the character of a receipt for use, it should be seen as a payment for use by the person who claims a deduction of the payment, and may be deductible by him as a working expense.

6.177 A taxpayer who has been denied a deduction under s. 51(1) in respect of a payment of a royalty, may be entitled to deductions under specific provisions providing for amortisation deductions over the life of wasting assets. Thus a taxpayer who has made payments under a *Stanton* ((1955) 92 C.L.R. 630) agreement may be denied deduction under s. 51(1), but be entitled to deductions under s. 124J spread over the period during which he fells the timber to which the payments relate. In some circumstances, though presumably not in the actual circumstances of *Cliffs International*, deductions may be available under Div. 10 (General Mining) of Pt III in respect of payments related to the acquisition of mining rights. Deductions may be available under Div. 10B of Pt III in respect of payments which are “expenditure of a capital nature on the purchase of” an item of commercial or industrial property. Where payments have been made by way of royalty in respect of the use of a patented process in the
construction of plant, deductions may be available under the general depreciation provisions of ss 54ff. In all these cases the deductions are spread over the life of the mine, the item of commercial or industrial property or the plant. The denial of deduction under s. 51(1) is only a denial of the earlier deduction that s. 51(1) may have given. Where amortisation or depreciation deductions are not available in the event of the failure of s. 51(1), a court might be the ready to find that s. 51(1) does give a deduction—to find, for example, that payments for know-how are deductible under the section; those payments cannot give rise to amortisation deductions unless the know-how includes patented processes. But the consequence that there will be no deduction at all if s. 51(1) fails, is not so much a mark of the inadequacy of s. 51(1) as a mark of the inadequacy of the amortisation and depreciation provisions of the Assessment Act. The proposition that there must be a gain if an item is to have the character of income (Chapter 2, Proposition 4 above), is asserted only of the individual item of income. Deduction by way of amortisation or depreciation of costs of wasting capital assets employed in a process of income derivation is necessary in all circumstances, if taxable income is to reflect overall gain by a taxpayer in a year of income.

6.178 It may be helpful to take the situations dealt with in [2.313]ff. above, in connection with the quality of income in the hands of the payee, and consider deductibility by the payer. It will be assumed in the discussion that there is a sufficient connection between the payment and a process of income derivation so that the element of relevance is satisfied, and the issue is therefore whether the payments are outgoings that are working, and thus deductible under s. 51(1), as distinct from capital payments, or, where the payments are outlays in the acquisition of trading stock, deductible by reason of s. 51(2), as distinct from capital payments. Problems may arise in regard to sufficient connection when the use made of the rights to which the payments relate is in part private, or when the payments exceed any commercially acceptable charge and they are made to an associated person. Problems of these kinds have been explored in relation to interest payments and will be further explored in dealing with the question of apportionment of an outgoing so as to deny part of the outgoing ([9.1]-[9.32] below).

Payments in respect of rights inherent in the ownership of land or other rights in relation to land

Payments for use, and payments for trading stock

6.179 It would be assumed that the payments in a McCauley ((1944) 69 C.L.R. 235) situation in respect of timber taken from land are deductible as
working expenses. They are costs of exercising the rights given to the payer by the licence agreement. And they may, in the application of the trading stock provisions, be seen as costs of trading stock and subject, if the timber remains on hand at year end, to what is in effect a deferral of deduction by the operation of s. 28. Payments under a McCauley agreement in respect of blue metal, sand or gravel would be deductible for the same reasons.

6.180 Deductibility of the payments in a Stanton (1955) 92 C.L.R. 630 situation is more doubtful. The payments may be deductible by reason of s. 51(2) as costs of trading stock. A number of United Kingdom decisions and one Privy Council decision are relevant: Golden Horse Shoe (New) Ltd v. Thurgood [1934] 1 K.B. 548, Stow Bardolph Gravel Co. Ltd v. Poole [1954] 1 W.L.R. 1503, Hood Barrs v. I.R.C. [1957] 1 W.L.R. 529, Hopwood v. C. N. Spencer Ltd (1964) 42 T.C. 169 and Kauri Timber Co. Ltd v. C. of T. (N.Z.) [1913] A.C. 771. The issue as it appears in these cases is whether the payments are for a source from which the taxpayer may replenish his stock, or for stock which, conveniently, will be held where it stands until it is taken by the taxpayer. If the latter is the correct description the payments will be treated as costs of trading stock, and subject to deferral under s. 28. Factors which point to the conclusion that the payments are costs of trading-stock are:

(i) the passing of property to the taxpayer in the things—trees, blue metal, sand or gravel—to be taken from the land, if the property passes at the time of the agreement under which the payments are made;
(ii) a short period within which the taxpayer is obliged or may be expected to remove the things from the land; and
(iii) the circumstances that the things are “ripe” for taking.

6.181 In Stanton there is an observation of the court that “in no proper sense could the agreement vest the property in the timber in the purchaser”. If the first factor is essential, the payments in a Stanton situation would not be deductible. The judgment of Buckley J. in Hopwood v. C. N. Spencer rather indicates that the first factor is essential, which would suggest that the drafting of an agreement otherwise on the Stanton model should provide expressly for the passing of property on a notional severance at the time of the agreement.

6.182 In Hopwood v. C. N. Spencer the expectation of the buyer of the timber was that clearance would take place within 7–10 years. It might be thought that such a period is too long to indicate an acquisition of stock as distinct from a source of stock, more especially when the agreement relates to trees which may continue to mature. The fact that the things to be taken
will continue to mature is emphasised in *Kauri Timber Co. Ltd v. C. of T. (N.Z.)* and *Hood Barrs v. I.R.C.* as a factor against a conclusion that there is an acquisition of stock. The fact that it was found in *Hopwood v. Spencer* that the timber was “ripe” for clearance is thus of some significance.

6.183 There are observations in *Hood Barrs* which may suggest that the timber acquired should not be more than is necessary to meet “current requirements”. Lord Cohen said (at 539–40): “Like [Lord Sorn in the Court of Session] I see no reason for doubting that under the ordinary contract for purchases of standing timber which a regular timber merchant makes to supply himself with his current requirements, the merchant is not acquiring a capital asset and is entitled to make the appropriate debit in his annual accounts. . . . In each case it must be, as counsel for the appellant admitted, a question of degree, and . . . I have no doubt but that in this case, as in *Kauri’s* case, what the appellant, under the agreements in question, acquired was not goods or stock-in-trade, but an enduring interest in the land and the natural increment of the trees of the nature of a capital asset.”

6.184 Where the things to be taken from land are not things that “mature” in any sense—such as sand, gravel or blue metal—the third factor is irrelevant. *Stow Bardolph Gravel*, at least as it is explained by Buckley J. in *Hopwood v. Spencer*, would indicate that the factor of passing of property determines deductibility. A payment for tailings lying on the surface of land, property in which passes under the agreement, may be deductible as the cost of trading stock as in the *Golden Horse Shoe*, but a payment for an interest in land involving a right to win gravel or sand, property in which passes only when the right is exercised, cannot be so regarded. It is a payment for a source of stock. In theory, at least, it should be possible to draft an agreement, in other respects on the model of *Stanton* (1955) 92 C.L.R. 630 that will pass property, at the time of the agreement, in sand or gravel notionally severed from the land. Yet one might wonder why deductibility should depend on some of the more esoteric aspects of property law. The reference to “current requirements” in the passage quoted from the judgment of Lord Cohen in *Hood Barrs* offers a more appropriate basis of determining deductibility. At least it will be acceptable if the acquisition in excess of current requirements will generate deductions under other principles, or under specific amortisation provisions. The possibility of deductions at the time the taxpayer draws on the source of supply of trading stock is considered in [6.194]ff. below. There is a specific amortisation provision in s. 124J which will allow deductions at the time of taking from a source of supply of timber. The deductions are of so much of the amount paid by the taxpayer to acquire
the right to take—a “right to fell standing timber”—as is attributable to the
timber felled during the year of income. Where s. 124J is applicable, the
question of the consequences under s. 51(1) of a payment under a Stanton
agreement in respect of timber becomes less important. Indeed s. 124J may
be a code that will displace the operation of s. 51(1). In any event, there
will not be substantial differences in effect between a deduction under s.
124J and any deduction under s. 51(1).

6.185 Where a series of payments are to be made in circumstances
otherwise within Stanton but not involving payments of a fixed sum, there
may be a case for deductibility. It will be important to know whether the
payments are to be made over the whole period during which the payer
might take from the land. If they are, there is the more room to assert that
the payments are for the trading stock that may be taken from the land
during the period to which the payment relates, rather than payments for a
source of stock.

6.186 The fact that a Stanton type payment has been calculated by
reference to the anticipated taking from the land ought not increase the
prospect of deductibility of the payment as a payment for trading stock.
Calculation by reference to anticipated taking does no more than relate the
payment to the amount of potential trading stock, and would not dictate a
conclusion that the payment was for trading stock as distinct from a source
of trading stock.

6.187 The discussion so far has assumed that the payments are made by a
taxpayer who has a non-exclusive licence to enter the land, though he will,
generally, have an exclusive right to take from the land. Where the
taxpayer has an exclusive licence to enter—a phrase intended to include
the situation of a lessee—and to take, his difficulties in establishing that
payments are for trading stock may be increased.

6.188 In a McCauley situation with the added fact of exclusive possession,
the characterisation of the payments triggered by taking as payments for
use that are working expenses, and may be costs of trading stock, should
not be the less appropriate. Where, however, there is a series of payments
not triggered by taking, the case the taxpayer might otherwise have made
that the payments are working expenses and for stock, at least when the
payments are spread over the period of taking, is that much weaker. The
conclusion that the payments are for a source of stock may appear to be the
more necessary. Exclusiveness of possession of the land whence the timber
was to be taken is one basis of distinguishing Kauri Timber from Hopwood
v. C. N. Spencer. Where the item that is to be taken is timber, s. 124J may
be applicable. Questions of interpretation of s. 124J may arise. It is arguable that
a taxpayer has not acquired “a right to fell standing timber” when he has
acquired a lease that includes a right to fell timber. And it is arguable that he has not acquired “land carrying standing timber”. The argument would be that “land” in this context refers only to the fee simple. If s. 124J does apply, issues as to the relationship between deductibility under that section and under s. 51(1), considered in [6.184] above, will arise.

6.189 Where there has been an outright disposition of a congeries of rights relating to land—the fee simple in land or a mining lease from the Crown—for a single amount, the prospect that the payer may be entitled to a deduction of what he pays as a cost of trading stock may appear remote. There will, in the case of the sale of the fee simple, be a passing of property in the thing to be taken from the land when property passes in the land itself. But there will be no time limit on the period within which the person acquiring the land may take, and, where trees are to be taken, there will be the prospect of continuing maturation. In the case of mining rights, there will be no passing of property until the thing is taken. This fact and the fact that taking is limited by the period of the mining title are not, presumably, enough to preclude a conclusion that the acquisition of the mining rights is an acquisition of a source of supply of the thing to be mined.

6.190 Where payments are made that are triggered by the exercise of some of the congeries of rights acquired, the case for deductibility is at its strongest and the scope of the decision in *Cliffs International Inc.* (1979) 142 C.L.R. 140 is raised. Where the fee simple in land has been acquired, *Cliffs International* is not directly in point, since the obligation to make payments will be for a set period, and not for the unlimited life of the rights of a fee simple owner. Jacobs J., at least, emphasised the fact that in *Cliffs International* the obligation to make payments triggered by taking extended over the whole life of the rights acquired.

6.191 Where the payments made are triggered by the exercise of mining rights, *Cliffs International* is authority that the payments are deductible, at least when the obligation to make payments extends over the life of the mining rights acquired. They are deductible as expenses of use that are working expenses, which, in an appropriate case may be treated as costs of trading stock acquired as a result of the exercise. It may be doubted that the payments will be held deductible where they extend over a period which is substantially less than the life of the rights acquired.

6.192 *Egerton-Warburton* (1934) 51 C.L.R. 568 must be read subject to *Colonial Mutual Life Assurance Society Ltd* (1953) 89 C.L.R. 428 and both cases must be read subject to *Cliffs International*. *Egerton-Warburton* did not involve payments triggered by the exercise of rights. The observations in the case supporting the deductibility of annuity payments that were the
consideration for the acquisition of the farming property by the sons from their father could involve a conclusion that payments made in a series for property used in a process of income derivation are deductible. No judgment in *Cliffs International* would go so far. *Colonial Mutual Life* denied deduction of payments triggered by the receipt of rents by the payer, though they were not rents from property acquired from the payee. Some property had been acquired from the payee, but the payments were triggered by rents received by the payer from other property owned by him. The property in fact acquired by the payer was a fee simple. The period over which payments were to be made was a term of years. *Colonial Mutual Life* is not overruled by *Cliffs International*, though the latter case may be thought to have opened the case to re-examination. Any re-examination, one would think, is unlikely to reach a different conclusion on deductibility on the actual facts of the case. *Cliffs International* may be seen in correct perspective if matters of legal title to property are not treated as dominant. The legal effect of the transaction and the subsequent liquidation of Basic, was to transfer mining rights, the interest in which could be traced to Howmet and Mt Enid through their ownership of shares in Basic, to Cliffs. The transaction had the effect of a sub-lease of the mining rights at a rental determined by the use made by Cliffs of those rights. The judgment of Barwick C.J. includes an attempt to reconcile such a view of the transaction with an extended form approach which would assert that the payments were for the mining rights, or rather for the shares in the company that had the mining rights: since the shares and, in turn, the mining rights became a capital asset of Cliffs the payments were not deductible. The reconciliation is in the assertion that the description of the payments in the transaction as consideration for the shares was simply a wrong description. It is of course only if some extended form approach is taken that this reasoning becomes, in the circumstances of *Cliffs International*, reasoning which must be escaped. There is nothing in the words of s. 51(1) which prescribes that expenses which are in law consideration for the acquisition of a capital asset are not deductible. A rule of this kind may be drawn out of judicial pronouncements, and it may be a useful rule so far as it expresses the principles contained in s. 51(1). A frank admission that the rule in the circumstances of *Cliffs International* is not useful is to be preferred to attempts at reconciliation of the kind offered by Barwick C.J.

6.193 Had the payments in *Cliffs International* been required for a period that was substantially less than the mining rights, the appropriate conclusion would have been that the payments were costs of acquiring those rights and not deductible under s. 51(1).
Deduction when the taxpayer draws on a source of supply of trading stock

6.194 Where the expenses incurred by a taxpayer are denied deduction under s. 51(1) because they are to be regarded as costs of a source of supply of trading stock, there is a question whether a deduction is allowable when items are taken from the source and then become trading stock. There is a principle of United Kingdom income tax law that when an item is held by a taxpayer other than as a revenue asset of a business he carries on, and he thereafter comes to hold it as a revenue asset of his business, he will be taken to have acquired the asset, for purposes of determining income derived in the conduct of his business, at a cost equal to its value at the time the asset became a revenue asset: Sharkey v. Wernher [1956] A.C. 58 and Taylor v. Good [1974] 1 W.L.R. 556 at 558, and cases cited at 559. The principle was accepted as part of Australian income tax law by the High Court in Curran (1974) 131 C.L.R. 409, though the application of the principle in that case is with respect, unacceptable. The asset in that case was acquired in the conduct of the business—it was at no stage held as an asset that was not a revenue asset.

6.195 The principle would apply to circumstances where a taxpayer has a supply of sand, gravel or the like on his land, and he enters on a business of selling the sand or gravel. He would be entitled to a deduction, as a cost of the trading stock, of the value of the sand or gravel in situ at the time of the taking.

6.196 Where the taxpayer may be said to have committed the land to the business of selling the sand or gravel, the principle would require that the deduction as the cost of the sand or gravel taken should be its value in situ at the time the land was committed to the business.

6.197 The principle would operate in the same manner where the item taken from the property is timber. In that case a conclusion should the more readily be reached that the land has become committed to a business of growing and selling the timber, so that the cost on taking will be the value of the timber in situ at the time of the commitment.

6.198 It is a short step from the principle in these applications to a principle that where a taxpayer acquires land as a source of supply of trading stock, be it sand, gravel, timber or other item, he should be entitled to a deduction, on the taking, of such part of the cost of acquisition of the land as relates to the trading stock taken. It is unfortunate that authority may stand in the way of that short step. The United Kingdom cases are not necessarily an obstruction. At least in Hood Barrs v. I.R.C. [1957] 1 W.L.R. 529, the possible application of the principle in Sharkey v. Wernher
is left open. Lord Morton said (at 538):

“Counsel for the appellant sought to put forward an alternative argument, in the event of his main contention being rejected. The argument was that the appellant would be entitled to deduct, in his trading accounts, for each year in which he exercised his right to cut down trees and made the resulting timber available for use in his business, a sum equal to the market value of that timber at the date when it was so made available. In support of this argument he cited the cases of Craddock v. Zevo Finance Co., Ltd 27 T.C. 267 at 279; Commissioners of Inland Revenue v. Williamson Brothers 31 T.C. 370; and Sharkey v. Wernher [1956] A.C. 58 at 73, 83-84. I am of opinion that this question did not arise under the case stated. . . . Consequently, I express no opinion on it.”

The possibility of a deduction arising at the time of taking is thus not excluded. White (1968) 120 C.L.R. 191 may however be thought to be an obstruction. Indeed it may be thought to be an obstruction to the application of the principle where land becomes committed to the business of selling timber after its acquisition.

6.199 In the case of timber, s. 124J may to a degree redress any failure of principles of deductibility under s. 51(1), but s. 124J is limited in its application. It applies only in relation to timber. It did not apply to timber in White because of the manner in which the timber was sold—through Stanton-type agreements. And when the provision does apply it applies in a most inappropriate way. The deduction allowed is the cost of the timber in the acquisition of the right to fell or in the acquisition of the land, which is only appropriate when the timber is committed to a business of selling timber at the time of the acquisition of the right to fell or the acquisition of the land. There are questions as to the relationship of s. 124J and s. 51(1) raised in [6.184] above.

Payments in respect of commercial or industrial property

6.200 The discussion in [6.179]–[6.199] above relating to payments in respect of rights in land and rights in relation to land, has canvassed issues of a kind that arise also in regard to payments in respect of commercial and industrial property. A payment under a non-exclusive licence triggered by the licensee's action under the licence will generally be deductible as a payment for use that is a working expense and may be a cost of trading stock. The payment will not be deductible if there is no process of income derivation with which the payment is connected, or where the action of the licensee, for example under a patent licence, relates to the construction of a capital asset. Where it relates to the construction of plant, the payment may be a cost of plant and subject to depreciation deductions under the provisions of ss 54ff.

6.201 Where there is a series of payments under a non-exclusive licence,
though not triggered by use, the payments are likely to be regarded as payments for an asset, being the right to use the item of commercial or industrial property, and not a working expense or expenses of acquiring trading stock by manufacture in the exercise of the licence. A payment for the right to use may be deductible under the specific amortisation provisions of Div. 10B of Pt III. The fact that the payments are income in the hands of the payee as receipts for use—Rustproof Metal Window Co. Ltd v. I.R.C. [1947] 2 All E.R. 454 supports a view that they are—does not determine deductibility by the payer, but has some bearing on the issue.

6.202 A single payment for a non-exclusive licence, though income in the hands of the payee, is probably not deductible under s. 51. It is a payment for the acquisition of the right to use the item of property and may give rise to amortisation deductions under Div. 10B. The fact that the amount of the payment has been determined by reference to an estimate of the extent of anticipated use does not, it is submitted, affect its character.

6.203 Where payments are made under an agreement providing for an exclusive licence the payments are the more likely to be held to be for the right to use and not deductible under s. 51(1), though there may be amortisation deductions under Div. 10B of Pt III. A single payment and a series of payments will, it is thought, be so regarded. The fact that a series of payments may be income in the hands of the payee, on the authority of I.R.C. v. British Salmson Aero Engines [1938] 2 K.B. 482, does not determine deductibility by the payer. The fact that the amount of the payment or the series of payments has been determined by reference to an estimate of the extent of anticipated use does not, it is submitted, affect its character. Payments that are triggered by the exercise of rights under an exclusive licence may be different. Treating a payment made on the exercise, and because of the exercise, of rights under an exclusive licence as a working expense, and, where appropriate, a cost of stock, rather than as a cost of acquiring the licence, may be supported by Cliffs International Inc. (1979) 142 C.L.R. 140, at least where the payments are to be made during the whole period of the exclusive licence.

6.204 Payments in respect of the acquisition of the whole congeries of monopoly rights given by an item of commercial or industrial property are the most likely to be denied deduction under s. 51, though amortisation deductions may be available under Div. 10B of Pt III. The fact that the amount of the payment or series of payments has been calculated by reference to an estimate of the extent of anticipated use does not, it is submitted, affect its character. Again payments triggered by the exercise of the rights acquired may be different. Deductibility will depend on the scope of the authority accorded to the decision in Cliffs International.
6.205 Deductions under s. 51(1), on the authority of *Cliffs International*, may be available where the alternative of Div. 10B of Pt III could not be available. Where the item of property is acquired by acquiring shares and liquidating the company, a form approach applied to the words of Div. 10B will defeat the taxpayer. He has not incurred “expenditure on the purchase of the unit of industrial property” (s. 124L(1)(b)). And it may be doubted that Div. 10B is applicable to allow deductions where the person who has acquired a unit of property derives income by licensing another to use the unit of property.

### Payments in respect of the acquisition of know-how

6.206 The deductibility under s. 51(1) of a payment for know-how triggered by the use of that know-how again raises the question of the scope of the authority to be accorded to the decision in *Cliffs International*. Deduction is doubtful if the payments do not extend substantially over the life of the know-how, though “life” in this context will involve some judgment.

6.207 If deductions are allowed under s. 51 of payments which, though triggered by use, do not extend over the life of the know-how, the prospect is opened of deductions under the section of expenses which are, in effect, costs of a capital asset.

6.208 There are no specific provisions of the Act allowing amortisation deductions of the cost of know-how, unless the know-how is the subject of monopoly rights as an item of industrial property, in which case Div. 10B is applicable. The availability of deductions under s. 51(1) is so much the more important to the taxpayer.

6.209 Know-how, it is assumed, is a capital asset, though there may be circumstances in which the taxpayer deals in information, in which event the cost of know-how may be deductible as a cost of trading stock, or it may be subtractable in determining a profit on sale of the information by the taxpayer who has acquired it, if know-how is not within the trading stock provisions.

### The Characterisation of Premiums Paid on Policies of Insurance

6.210 In Chapter 2, [2.523]ff. above, attention was given to the question of the income character of receipts under policies of insurance. A receipt will be income if its function is to substitute for a revenue asset, for income that would have been derived if the event insured against had not occurred, or
for a loss or outgoing on revenue account. The purpose of the insurance bears on the determination of the function of the receipt, and purpose, in this regard, is a conclusion from evidence of subjective purpose and objective inference of purpose.

6.211 There is some correlation between the income character of a receipt under a policy of insurance and the deductibility of a premium paid on that policy, but there is no necessary correlation. So far as deductibility of a premium depends on purpose, it is the purpose of the payment of the premium that is relevant. The purpose of the policy may give to the purpose of the payment of premium the quality of relevance to the derivation of assessable income. But there may be a purpose in the payment of the premium which will deny the payment a working character. The payment may be a single amount paid for cover for a number of years. Or the payment may be payment in advance of premiums that would otherwise have been paid over a number of years. The payment may thus be directed to the securing of a “lasting advantage”, and be a capital outgoing. The discussion in [6.117]ff. above of Ilbery (1981) 81 A.T.C. 4234, 81 A.T.C. 4661, concerned with the payment of interest in advance, is relevant.

6.212 A payment of a premium so as to secure a lasting advantage is one illustration of circumstances where a premium is not deductible though it is relevant to some process of derivation of income. There is another. A premium paid on a policy of insurance will not be deductible if the premium was paid, not to maintain the business against the cost of an outgoing, but to ensure that there would be funds to meet that outgoing. The distinction may, at first sight, appear to be verbal only. But it has the support of the Federal Court in Ransburg Australia Pty Ltd (1980) 80 A.T.C. 4114. The principle that is sought to be expressed will distinguish a payment to maintain the business by providing funds to meet an expense which is a misfortune, from a payment to provide funds to meet an expense arising from an event which is a normal experience in conducting the business. The premium paid on the policy in Carapark Holdings Ltd (1967) 115 C.L.R. 653 affords an illustration of a payment to maintain the business: the premium ensured that funds would be available to meet expenses made necessary by the death in an air accident of one of the employees of the taxpayer's subsidiary. Those expenses are not ordinary expenses of carrying on business but were expenses of an extra-ordinary kind, against which the business might want protection. The premium paid in Ransburg is an illustration of a payment made to ensure that there would be funds to meet an outgoing—an outgoing in a long-service leave payment—which was a normal experience in conducting the business. The
premium paid in *Ransburg* was not a maintenance payment. It was paid for the advantages, not of enjoying protection against the misfortune of an event and thus the maintenance of the business against that event, but of having funds available to meet an ordinary expense in carrying on the business.

6.213 The principle expressed in the last paragraph suggests a lack of correlation between the character of the payment of a premium and the character of a receipt under the insurance policy, where the premium is paid to ensure that money will be received to meet a normal business expense. There will however be a correlation if the receipt is held not to be income. We have been asked to accept one qualification on the compensation receipt principle: the principle does not apply to a refund of an amount that is an allowable deduction. Another qualification, applicable to an amount received in the event of the incurring of an ordinary business expense, might insist that an amount is not received by way of compensation—it does not substitute for an expense—if the receipt serves the same function as the return to the taxpayer of moneys left with another to be returned on the incurring of the business expense. It is only if some rule in regard to insurance receipts is adopted, and an extended form approach applied in the operation of the rule, that there is any difficulty in the way of recognising the qualification. There is an evident distinction in commercial significance between the receipt under the insurance policy in *Carapark*, and the receipt under the insurance policy in *Ransburg*. A commercial distinction is recognised in regard to the payment of the premium, by the decision in *Ransburg* that the premium was not deductible, when, at least in the view of this Volume the premium in *Carapark* was deductible.

6.214 A policy of insurance providing for the payment of an annuity is another illustration of circumstances where there is a want of correlation between the income character of a receipt under a policy of insurance and the deductibility of the premium. The receipts of the annuity are income to the extent explored in [2.175]ff. and [2.215]ff. in Chapter 2 above. The premiums are not deductible, though they may be subtractable under the specific provisions of s. 27H, in determining how much of the annuity receipts are income. The assumption in these statements is that the receipts are income only because of their character as an annuity. If the policy may be seen as a policy to provide compensation for the loss of income flows, as it was in *D. P. Smith* (1981) 147 C.L.R. 578, different consequences may follow, both in regard to the income quality of receipts and the deductibility of the premium. The matter is more closely considered below in dealing with *D. P. Smith* ([6.226]–[6.229]).
6.215 Want of correlation between income character and deductibility will arise if a deduction of the premium is allowed, while a receipt under the policy is not income. It would be generally assumed that premiums for insurance against fire of property used in a business or of property whence income is derived, are deductible, though it is not suggested that, unless by the operation of specific provisions, a lump sum receipt under the policy is income. The premium is deductible as an expense relevant to the derivation of income, that is a working expense because its function is to maintain the property employed in the process of income derivation. It's function is parallel with the function of a payment of rates on property used in a process of income derivation.

6.216 It may be helpful to focus the discussion on each of a number of classes of insurance policies.

**Premiums for insurance of property against damage by fire or other misfortune**

6.217 A premium for annual cover is deductible if the property is used exclusively in a process of income derivation. If the property is only partly so used, questions of apportionment so as to deny a full deduction are raised. The discussion in [6.81]-[6.170] above in regard to interest, rent, rates and repairs, is relevant.

6.218 If the premium is paid for cover for a term of years, or if premiums for a number of years are paid in advance, the payments may be denied deduction on the ground that they are not working expenses. Where the payments relate to a relatively short period of years, they may be deductible. There is some room for a development in principle whereby the deduction in the year of payment will be confined to an amount that is referable to cover in that year, and the balance of the payment will be deductible as it is consumed in cover afforded in subsequent years. The discussion in [6.125] above in relation to *Ilbery*, is relevant.

6.219 Deductibility of the premium is not affected by the fact that receipts under the policy will not be income. A receipt under the policy will be income if its function is compensation for the income lost as a result of the insured event. A receipt will not be income if its function is to compensate for the loss of the value of the property itself, unless the property is trading stock or other revenue asset. But the premium will be deductible if its purpose is to maintain the investment in the business that the property represents, or in the property whence income is derived, against misfortune. It will have that purpose, whether the function of a receipt under the policy is to substitute for the value of property lost by the insured event, or the loss of income flows arising from that event, or both of these.
The notion of maintaining the investment includes maintaining the process of derivation of income inherent in that investment. The assumption in these observations is that the policy of insurance is a contract of indemnity. A premium on a policy which provides for an agreed amount that may exceed an indemnity, may fail the requirement of relevance, and, if it does not, may yet fail the requirement that it must be a working expense. The premium may be seen as an investment, like the premium in *Ransburg*.

**Premiums for insurance against loss of income arising from some misfortune, other than physical injury to the taxpayer's person**

6.220 It follows from the discussion under the last heading that premiums for cover against loss of income arising from some misfortune are deductible. One matter may require further emphasis. Deductibility of the premium does not depend on receipts under the policy being income. It is the factor of maintaining the investment that gives deductibility to the premium. There is a tendency to read the word “producing” in the phrase “in gaining or producing” in s. 51(1), in a way that would make it a test of deductibility that some income can be traced to the outgoing. It is evident in the “direct effect on income” test of deductibility of an employee's outgoings, for which *Hatchett* (1971) 125 C.L.R. 494 is regarded as authority. Tracing in that context may be helpful as a demonstration of relevance of the expense. But it is not helpful in the present context, where the question is whether the expense is a working as distinct from a capital expense.  

6.221 If tracing is adopted as a test of working character, it may yield a conclusion that the premium on a policy for an annuity is a working expense, and that would be an unacceptable conclusion. The income to which an outgoing must be relevant, and in regard to which it must have a working character, is the income to which the income earning operations or the investment are directed. Premiums on policies now being considered are relevant and working because they maintain the business operations or the process of deriving income from property, not because receipts under the policies are income under the compensation principle.  

6.222 There are suggestions in *D. P. Smith* (1981) 147 C.L.R. 578, considered in [6.272]-[6.229] below, that the income character of receipts under the policy bore on deductibility in that case. A conclusion that the receipts would be income depended on a conclusion that their function was to substitute for income flows and, in turn, on a conclusion that the purpose of the policy was to maintain those income flows against the insured event.  

6.223 But this legitimate bearing on deductibility is different from a
bearing of the kind that would assert that, because the receipts under the policy are income and were “produced” in some sense by the premiums, the premiums are deductible. That kind of bearing seems to be suggested in the judgment of Murphy J. in the observations (at 587):

“If the premiums were paid to achieve a lump sum payment, for example for the loss of an eye, or for total or even partial permanent incapacity, presumably this should be treated as a capital receipt and the premium paid should be treated as of a capital nature. In general, if receipts under such a policy would be treated as income, the premiums should be treated as allowable expenditure, and if the receipts would be treated as capital the premiums should not be allowable expenditure. Of course, there are circumstances where the premiums could be regarded as paid to acquire, if the contingency occurred, a benefit in the nature of an annuity; although the periodical sums received would be income, the premium could be regarded as paid to obtain a capital asset, the annuity.”

The observation, in the passage quoted, on the appropriate treatment of premiums on a policy for the payment of an annuity on the happening of a contingency, may indicate the difficulty with any analysis that looks to what was produced. Premiums on a policy for an annuity will not be deductible where the contingency does not involve the loss of income flows, because they are not relevant to the derivation of income. To say that they are not deductible because they are directed to producing a capital asset is not helpful. The right to the receipts after the happening of the contingency in *D. P. Smith* is as much a capital asset as the right to an annuity.

**Premiums for insurance against physical injury to the taxpayer's person**

6.224 Where the function of a receipt under the policy is to provide an amount that will serve as a solatium and compensation for the loss of earning capacity resulting from the physical injury, the receipt will not be income. So far as the receipt will be a solatium, there is no basis on which it might be held to be income. So far as the receipt will be compensation for loss of earning capacity, it will be a substitute for an asset that is not an asset of any business or employment, nor is it an asset whence income is derived. It is irrelevant that the taxpayer may be engaged in a business operation or be in employment.

6.225 A premium paid on a policy which provides for such a receipt is not deductible under s. 51(1). It fails the requirement of relevance. It is true that a premium on a policy of insurance against fire, which provides for the payment of a single sum which will substitute for the value of the property lost, is deductible as a relevant and working expense where the property is an asset of a business, or is property whence income is derived. But bodily integrity of a taxpayer cannot be equated with plant in a factory. A premium for insurance of plant against loss by misfortune is an expense of maintaining the investment in the plant, and is deductible for this reason. A
receipt under the policy will enable the restoration of the investment. A premium for insurance of the bodily integrity of a taxpayer does not admit of such descriptions. The premium paid is an irrelevant expense for the same reason that, generally, medical expenses which are directed to maintaining or restoring bodily integrity are not deductible. They are not relevant, and may be described as personal outgoings. It is true that there is a connection with the derivation of income, but it is an even more remote connection than that held insufficient in *Lunney* (1958) 100 C.L.R. 478—concerned with the deductibility of fares to and from work.

**6.226** Where the function of a receipt under a policy of insurance against bodily injury to the taxpayer is to substitute for income flows that would have been derived, different conclusions are open as to both the income character of a receipt, and to the deductibility of the premium. A finding that the function of a receipt is to substitute for the loss of income flows, and is income under the compensation receipts principle, is the more likely if it is one of a number of receipts for which the policy provides, and if the right to a receipt depends on some showing of loss. If this is the function of receipts under the policy, deductibility of premiums paid may be supported by regarding them as payments to maintain income flows from a process of income derivation. This would appear to be the basis of the conclusion in *D. P. Smith* (1981) 147 C.L.R. 578 that the premiums were deductible, though the judgment of Murphy J. expressed other reasoning that would make deductibility depend on the “production” of actual receipts which are income ([6.223] above). There is some suggestion of that kind of reasoning in the judgment of the majority (at 586):

“...It is true that the payment of the premium in June 1978 did not result in the generation of any income in that year, but there is a sufficient connection between the purchase of the cover against the loss of ability to earn and the consequent earning of assessable income to bring the premium within the first limb of s. 51(1).”

The suggestion is, however, neutralised by the earlier statement of general principle (at 586):

“...What is incidental and relevant . . . falls to be determined not by the reference to the certainty or likelihood of the outgoing resulting in the generation of income but to its nature or character.”

As a matter of administrative feasibility, deductibility of a premium could not be made to depend on the generation of receipts under the policy. But in the present context, it seems that while they are theoretically separate issues, deductibility of the premium and income character of any receipts that may arise under the policy are practically inseparable issues. A policy might provide for commutation of a series of receipts whose function is to substitute for income flows. It might be said that in this instance the function of the payment of premiums may remain the maintaining of
income flows, though a receipt under the policy will not be income, the assertion being that a receipt in commutation of receipts that would be substitutes for income flows is not income. But the assertion that the commutation receipt would not be income would be unfounded. Apart from the possible operation of the eligible termination payment provisions of Subdiv. AA of Div. 2 of Pt III, considered in this respect in [2.214] above, which would depend on a finding that the receipts commuted would have been an annuity, there is ground for treating the commutation receipt as income. The commutation receipt has the character that the receipts commuted had. The periodicity of those receipts was only an indication of that character. It was not essential to that character.

6.227 A finding that the function of a receipt under the policy is to compensate for the loss of income flows is the more likely if the policy requires some showing of loss as a condition of a right to a receipt, and if compensation from other sources affects the amount of any compensation under the policy. A conclusion that the function of the receipt was to compensate for the loss of income flows was reached in *D. P. Smith* (at 584):

“In our opinion the conclusion is inescapable that the purpose of the policy is to diminish the adverse economic consequences of injury by accident. It was to provide a monthly indemnity against the income loss arising from the inability to earn.”

The monthly payments were payable, after a waiting period of 30 days, while the insured was unable to perform “each and every gainful occupation for which he [was] reasonably suited . . . ”. Actual loss of income did not have to be shown. The taxpayer in fact received sick pay from his employer for a period, and there was no provision for reduction of the payments by reference to such amounts. On the other hand, during the first two years of disability, he was entitled to payments only if he did not engage “in any occupation or employment for wage or profit”, and there was provision for reduction of payments by any amounts paid to the taxpayer under worker's compensation legislation.

6.228 The finding as to the function of the receipts in *D. P. Smith* did not depend on any precise correlation between the receipts and pecuniary loss. “It is not necessary”, it was said in the principal judgment (at 583), “to look for an indemnity measured with any precision against the loss”. Where there is no correlation between a series of receipts and pecuniary loss, the conclusion may be that the function of the payment is to provide an annuity. In which event the receipts will be income, but the premiums will not be deductible, though they may be subtractable under s. 27H. Where the policy provides for a single amount payable by reference to the nature of the injuries, and not to some continuing disability, the function of a receipt is the more likely to be found to be solatium and, perhaps, compensation for loss of earning capacity. In some cases, the policy may provide for payment of a single amount, and for periodical amounts related to disability. The prospect is then opened that the single amount will not be
income, while the other receipts are income. Deductibility of premiums under such a policy may raise a problem of apportionment considered below in Chapter 9.

6.229 The taxpayer in *D. P. Smith* was an employee. It is significant that the Full High Court allowed a deduction of the premiums, notwithstanding that there was no express or implied term in his contract with the hospital that employed him, that he would take out a personal disability insurance policy. The premium expenses were incurred in his discretion. There is an assumption reflected, possibly, in the judgment of Rogers J. in *Adler* (1981) 81 A.T.C. 4687, that an employee's expenses will not be held to be relevant to the earning of his employment income unless there is an express or implied term in his contract of service that he will incur the expenses, or the expense will have a direct effect on income from the employment. The decision in *D. P. Smith* that the payment of premiums were deductible outgoings is a rejection of that assumption. At least in the principal judgment, the view was that the income to which the premiums were relevant was the employment income, not the receipts under the policy. There was nothing, express or implied, in the employee's contract that required him to make the payments, nor could it be said that the payments of premiums had a direct effect on his employment income. The matter of relevance of an employee's expenses to the derivation of his employment income is considered below in [8.41]-[8.48].

**Premiums for insurance on the life of the taxpayer or of another person, or for insurance against bodily injury suffered by another**

6.230 A premium paid by the taxpayer for insurance on his own life, whether the cover is annual or whole of life, is not deductible. The reasons are extensions of the reasons given under the last heading in relation to a policy providing for payment of a single amount in the event of the suffering of bodily injury. The reasons are the more compelling where the insurance is on the life of the taxpayer, and not simply against impairment of his bodily integrity.

6.231 Where the policy includes a provision for what will be described as an annuity, on attaining a specified age, an argument might be made that the premiums are deductible. The argument would be that they are paid to maintain the income flows that are likely to be lost by retirement. A similar argument, perhaps with greater force, might be made where the issue is the deductibility of contributions made to a superannuation scheme which provides for a pension on retirement. The notion of maintenance in any such argument is clearly different from the notion identified by the word in
earlier discussions in this chapter. The payments of premium or contributions are made in the purchase of the annuity or pension. They are not relevant to present income flows by ensuring that substitutes for them will be continued if they cease as a result of misfortune. They are paid for new income flows, which may commence on the relinquishment of present flows. The factor of indemnity against loss, granted that it need not be precise, is simply not present as it was in *D. P. Smith* (1981) 147 C.L.R. 578.

6.232 The deductibility of premiums on a policy on the life of another, or against bodily injury suffered by another, raises different issues. The principles established in *Carapark Holdings Ltd* (1967) 115 C.L.R. 653 in relation to the income character of amounts received under an annual policy on the life of another are equally applicable to amounts received under a policy providing for amounts to be paid to the insured in the event of bodily injury to another. The deceased was the employee of a company that was a subsidiary of the taxpayer. The function of the receipt under the policy, as the court found, was to substitute for dividend income that would not flow from the subsidiary if the subsidiary's profit suffered as a result of the loss of an employee. Alternatively, it was to provide the funds to meet revenue expenses that would be incurred in showing generosity to the relatives of the deceased employee. *Carapark* did not involve deductibility of the premiums. They would be deductible as payments to maintain the flow of income from the subsidiary, or to maintain the taxpayer's investment in its own business against the need to incur expenses arising from the insured event.

6.233 In *Carapark* the receipt under the policy was a single amount, which may have suggested that the receipt substituted for some part of the value of the taxpayer's investment in its subsidiary—the value dependent on the continued availability of the deceased's services to the subsidiary—though it would not have weakened the inference that the receipt was to provide funds to meet revenue expenses. A view that the receipt substituted for some part of the taxpayer's investment would have required a conclusion that the receipt under the policy was not income, though it would not have required a conclusion that the premiums were not deductible: the premiums would remain deductible as payments to maintain the property whence income was derived.

6.234 Premiums on a whole of life policy on the life of another may be regarded differently from premiums on annual policies. The function of a receipt under such a policy may in some circumstances appear to be the same as in *Carapark*, and the receipt income, but the fact that the cover may extend beyond the period when the taxpayer has any business interest
in the survival of the person whose life is insured may tell against a Carapark finding of function. Where the taxpayer has in fact ceased, at the time of death, to have any business interest in the survival, the receipt will be simply the return of an investment. It may be that it should be so regarded whenever the receipt occurs. Whatever the conclusion on income character of a receipt, the premiums are likely to be denied deduction, if not on the ground that they are irrelevant, then, as in Ransburg (1980) 80 A.T.C. 4114, on the ground that they are not working expenses.

**Premiums for insurance that will indemnify the taxpayer against expenses**

6.235 There is a distinction to be drawn between insurance to provide funds to meet expenses that have to be incurred because of misfortune, and insurance to provide funds to meet ordinary business expenses. The former covers the insurance in Carapark Holdings Ltd (1967) 115 C.L.R. 653, the latter the insurance in Ransburg Aust. Pty Ltd (1980) 80 A.T.C. 4114.

6.236 Carapark decided only the question of income character of the receipts. The formulation, in this case, of a rule for this purpose may be too wide. A general statement that a receipt whose function is to substitute for a loss or outgoing on revenue account, may involve a conclusion in the facts of Ransburg that the receipts under the policy are income. Such a conclusion would equate the treatment of Ransburg insurance with the purchase of an annuity, with the difference that the payments of premium, not deductible in either case, may in the case of the purchase of an annuity attract the tax relief given by s. 27H. It is assumed that receipts under a series of Ransburg insurance policies are not an annuity within the meaning of that word in s. 27H.

6.237 A conclusion that receipts under a Ransburg insurance policy are income will not be drawn if any rule in Carapark which would lead to that conclusion is reframed, in a manner suggested in [6.213] above.

6.238 Where premiums are paid for insurance that will provide funds to meet expenses that have to be incurred because of misfortune, the premiums will be deductible. Where the premiums are paid for insurance that will provide funds to meet ordinary business expenses, they will not be deductible. Where the function of receipts under the policy is to save the investment in the business, or other process of income derivation, harmless against expenses arising from misfortune, the premiums may fairly be seen as maintenance expenses. Where the issue is deductibility of the premiums, it does not matter whether the expense arising from misfortune is a working or a capital expense. Where the function of the receipts under the policy is to provide funds to meet ordinary business expenses or other
6.239 The distinction between expenses arising from misfortune and ordinary expenses, while manifest in the distinction between the Carapark expenses (the result of the death by accident of an executive) and the Ransburg expenses (expenses of long service leave payments to employees) may not always be easily drawn. Inevitably there will be circumstances in a marginal area. If the insurance in Ransburg had related to long service leave rights which were not yet fully vested in the employee, expenses would not have been so obviously different from the Carapark expenses.

6.240 In Adler (1981) 81 A.T.C. 4687 the only question raised was relevance. Expressed in terms of the distinction drawn in previous paragraphs, it was assumed that the expenses to which the insurance related were expenses arising from misfortune—“loss” which the taxpayer “shall have been obliged by law to pay” as a result of a claim made against him, as a director of several companies, “for a wrongful act”. It might be asked how premiums paid by a newspaper proprietor on a policy giving indemnity against liability for defamation are to be regarded? The distinction between expenses arising from misfortune and expenses which are ordinary business expenses, even if judicially endorsed, should not become part of a rule which will attract an extended form approach. In some industries “misfortunes” are an ordinary business experience, and the distinction drawn is not helpful. The principle expressed in the decision in Ransburg will require some other formulation of a rule, perhaps in terms of likelihood of the insured event. Such a rule would need to be expressed in terms of degree. Ransburg cannot be explained in terms of certainty that the experience of making long service leave payments would be incurred. The taxpayer might have sold the business to another, in which event liability to make long service leave payments would pass to that other.

6.241 The decision in Adler on the issue of relevance may reflect an assumption, referred to in [6.229] above, that a more stringent test is required by s. 51(1) to determine the relevance of an expense when the income with which it is connected is employment income. Rogers J. simply adopted the view of the Board of Review that only the second limb of s. 51 (1) would support deductibility of the premiums paid, so that the taxpayer's success depended on his showing that he was carrying on the business of a company director. The assumption would seem to be that the premiums could not be relevant to employment income unless that income could also be described as business income. It will be indeed strange if a premium on a policy such as in Adler is not deductible by an executive director who has
only one office as director, unless it is a term of his contract of employment that he should take out the insurance.

The Characterisation of Payments arising from the Giving of a Guarantee

6.242 *Ransburg Aust. Pty Ltd* (1980) 80 A.T.C. 4114, considered above in relation to the deductibility of insurance premiums, is authority, if authority is necessary, for a principle that a payment to another of an amount on terms that the other will return that amount is not deductible. The payment is an outlay, not an outgoing. The outlay may give rise to a loss deduction if there is a failure to repay. A moneylender, it will be seen, is entitled to a loss deduction if a loan he has made in the course of his business is not repaid: the loss is relevant and working. A payment to a company by way of a subscription for shares is an outlay that may give rise to a loss deduction if the company goes into liquidation and is unable to return the capital subscribed: deductibility of the loss will depend on whether the shares are revenue assets of the taxpayer who has subscribed for them.

6.243 The treatment of a payment under a guarantee expresses the same principle. The payment is not an outgoing, since there is a right to repayment arising from subrogation to the rights of the creditor who has received payment from the taxpayer-guarantor. A failure by the debtor to pay the taxpayer may give the taxpayer a loss deduction. There will be a loss deduction if the giving of the guarantee is an act done in carrying on a business, so that the rights resulting from subrogation are revenue assets of that business: the loss is thus relevant and working.

6.244 Where it is apparent at the time of payment under the guarantee that the rights resulting from subrogation are worthless—the debtor may be a company that has already been liquidated—there is an immediate deduction available to the guarantor, if the giving of the guarantee was an act done in carrying on the business. In these circumstances distinguishing an outgoing from a loss is not significant.

6.245 Where the giving of the guarantee relates to an investment by another in an entity in which the taxpayer-guarantor is interested, whether the investment is a loan to the entity or the allowing of credit in some transaction with the entity, the character of the guarantee and of a payment under the guarantee will reflect the character that an investment by the taxpayer himself would have had. If a direct investment would have been the acquisition of a revenue asset, a payment under the guarantee will be seen as the acquisition of a revenue asset, with the prospect of a loss
deduction if the rights of subrogation fail to realise the amount of the payment. The circumstances in which a direct investment will involve the acquisition of a revenue asset are considered in [2.456]ff. above. Generally, the giving of the guarantee and payment under the guarantee will not be acts in carrying on a business. They are unlikely to be such where the taxpayer's interest in the entity is, for example, the interest of a shareholder in a private company. The making of the payment under the guarantee and the failure of the subrogation rights to realise the amount of the payment may involve a relevant loss, but it is not a working loss. A loan by the taxpayer made directly to the entity would not be a revenue asset. In *English Crown Spelter Co. Ltd v. Baker* (1908) 5 T.C. 327 a loan to a subsidiary was held to be a capital asset. The loan to the subsidiary by the taxpayer in *Total Holdings (Australia) Pty Ltd* (1979) 79 A.T.C. 4279 was, presumably, a capital asset. Had a payment of interest been in fact made by the holding company in *Marbren Pty Ltd* (1984) 84 A.T.C. 4783 in respect of the loan made to its subsidiary, it would not, it is submitted, have been deductible. The payment should be seen as an investment in the subsidiary that was not a revenue asset.

6.246 Where the giving of the guarantee relates to an investment by another in an entity in which the taxpayer guarantor has no interest, except an indirect commercial interest, the characterisation of the guarantee and of a payment under it becomes more difficult. A taxpayer may guarantee a loan made to another who is a supplier of goods to the taxpayer or is an outlet for the taxpayer's production. The character of the guarantee and of a payment under the guarantee will reflect the character that a loan made directly to the supplier or outlet would have had. The possibility that such a loan would be a revenue asset is considered in [6.316] below. There is a difference, one would think, between a loan to one of a number of suppliers or outlets, and a loan to a sole supplier or outlet. A loss on either kind of loan may be relevant, but a loss on a loan of the former kind is the more likely to be held to be a working loss. *Charles Marsden & Sons Ltd v. I.R.C.* (1919) 12 T.C. 217 is an illustration of what was treated as a loan to a supplier, held to be capital. The loan was made to a new supplier and was made, in the view of Rowlatt J. “in order to establish [a] source of . . . supply” (at 225).

6.247 The obligation of the debtor that is the subject of the guarantee may be an obligation to repay money lent to him, or to pay for goods or services supplied to him. The obligation may have attached to it an obligation to pay interest on the debt, an obligation that is also covered by the guarantee. It may be thought that the payment under the guarantee should have the same character as a payment by the debtor would have had. If a payment
made by the debtor would have been a payment for goods or services or by way of interest, it would be said that the payment by the guarantor under the guarantee should be treated as if it were such a payment. There is no principle which would support such a transfer of character. The payment under the guarantee, on the analysis adopted in preceding paragraphs, is an investment in the debtor. It does not take its character from what would have been the character of a payment to the creditor by the debtor. In any event, the transfer of character would be insufficient to give the quality of deductibility to a payment under the guarantee. A payment for trading stock is deductible only if made by the person who acquires what is trading stock of his business. A payment of interest is deductible only if it is a payment of interest on money used by the taxpayer in a process of income derivation carried on by him.

6.248 There are related questions. Does a receipt by the creditor under the guarantee take the character a receipt from the debtor would have had? The operation of the compensation receipts principle (Proposition 15, [2.506]ff. above) and s. 26(j) ([4.204]ff. above), in this context, is that a receipt under the guarantee which substitutes for a receipt that would have been income is income of the receiver. To this extent the character that a receipt from the debtor would have had is transferred to the receipt from the guarantor. There will however remain a further question whether a more particular character of a receipt from the debtor is transferred. A liability to withholding tax may arise under Div. 11A of Pt III if a non-resident receives a payment of “interest” from a resident. One view would be that even if the receipt by the creditor may be said to be “interest” in his hands—the matter raised is the scope of that word as used in Div. 11A—it is not a payment of “interest” by the guarantor. The guarantor does not make the payment to service credit made available to him. The judgment of Megarry J. in Re Hawkins [1972] 3 All E.R. 386 may support the view that there is a receipt of “interest” by the creditor, but it does not bear on the question whether there is a payment of “interest” by the guarantor.

6.249 The discussion so far has been concerned with payments under guarantee, where the guarantor who pays has rights of subrogation. The analysis adopted equates the payment under the guarantee with a direct investment in the entity whose obligations are guaranteed. The possible deduction is a loss deduction, and it is available if the investment is a revenue asset. This analysis is not open where the taxpayer has given a simple indemnity, and makes a payment which does not give rise to rights of subrogation or rights in quasi-contract, to recover what he has paid. None the less an analysis of this kind may be best adapted to the commercial effect of the transaction. A holding company that discharges
an obligation of its subsidiary, whether to repay a loan, or to pay for goods or services supplied to the subsidiary, has, in effect, invested in the subsidiary. It may anticipate the return of its investment, whether in a dividend distribution or alternatively on liquidation. A payment by a holding company in pursuance of an indemnity given to the lender or to the supplier to the subsidiary, should be regarded in the same way. The investment is not a revenue asset, and will not generate a loss deduction. The investment may be treated as a laying out of money in order to derive income, so that, on the authority of Total Holdings (Australia) Pty Ltd (1979) 79 A.T.C. 4279, interest on money borrowed by the company for the purpose of making the investment in the subsidiary, will be deductible. But the investment, in line with the analysis of a payment under a guarantee adopted above, does not attract the character and the deductibility that a payment by the subsidiary would have had. Where the obligation of the subsidiary relates to the supply to it of goods or services, a deduction will be available to the subsidiary, assuming it is on an accruals basis of accounting, and, presumably, the discharge of that obligation by the holding company is not a derivation of income by the subsidiary.

6.250 A payment to discharge an obligation of another, unattended by any right to recover the amount paid, is unlikely to be made save in the holding company and subsidiary situation, or in an individual and wholly owned company situation. If it is made, in situations other than these, the payment is an outgoing and deductibility will depend on relevance and working character. Where it is made under an indemnity, the purpose in entering into the indemnity agreement will determine the purpose of the payment. Where it is made otherwise than under an indemnity agreement, the purpose of the payment will need to be identified. The relevant purpose of the payment is the taxpayer's purpose, and not the purpose the entity whose obligation is discharged would have had if it had made the payment. A purpose that will make the payment relevant and working will have its equivalent in the purpose that would make an investment in the entity a revenue asset, or in the purpose a taxpayer might have in making a gift to the entity. A purpose of promoting sales to the entity, or a purpose of securing supplies from the entity, by ensuring the continuance of the entity and its goodwill is the most likely. Such a purpose will give relevance to the payment, though there remains the prospect, explained in relation to payments under guarantees ([6.246] above) that the payment may not be working where the entity's continuance and goodwill are of special importance to the taxpayer.

6.251 The discussion has so far assumed that the taxpayer that gives the
guarantee is not engaged in a business of giving guarantees for rewards. If it is, any investments that result from payments under guarantees will be revenue assets and may give rise to loss deductions. Moreover the discussion has been confined to payments under guarantees, in the sense of promises to answer for the debt or default of another. Payments under “guarantees” given by a seller as to the quality and durability of goods sold, will generally be deductible as expenses of selling in a business of selling.

The Characterisation of Payments to Trade, Business, Professional and Employee Associations

6.252 There are specific provisions in s. 73 in regard to the deductibility of payments in respect of membership of an association. A deduction not exceeding $42 is allowable in respect of any periodical subscription in respect of membership of any trade, business or professional association (s. 73(3)). In certain circumstances a more generous deduction may be allowable under the section. There is no limit on the amount of a periodical subscription that is deductible if the carrying on of a business from which assessable income is derived by the taxpayer is conditional upon membership of an association, and the subscription is paid in respect of that membership (s. 73(1)). Where an association carries out, on behalf of its members, any activity of such a nature that, if carried out by the taxpayer on his own behalf, the expense of that activity would be an allowable deduction by the taxpayer, any subscriptions, levies or contributions to the association by the taxpayer are deductible by the taxpayer, subject to a ceiling of $42, or, if it is greater, a ceiling of so much of the subscriptions, levies or contributions as have been or will be applied by the association to meet losses or outgoings in carrying out that activity, other than losses or outgoings of capital or of a capital nature (s. 73(2)).

6.253 The deduction under s. 73(3) is allowable whether or not it is relevant to a process of income derivation in a sense of relevance that would satisfy one of the requirements for deductibility under s. 51(1), though some connection will very likely follow from the requirement that the association to which the periodical subscription is paid should be a trade, business or professional association. The deduction under s. 73(1) has its own test of relevance. The requirement under s. 73(1) that the subscription must be a periodical subscription goes some way to ensuring that the subscription is a working expense, in a sense that would ensure deductibility under s. 51(1). But the fact that a periodical payment secures a lasting advantage and would be not working but capital and be denied
6.254 A deduction under s. 73(2) is available provided the association carries out, on behalf of its members, in the year of income, any activity of such a nature that, if carried out by the taxpayer on his own behalf, its expense would be an allowable deduction to him. Circumstances can be envisaged where this activity constitutes only part of the association's total activity. The activity will none the less support a deduction of the whole subscription, subject to the ceiling set by the subsection.

6.255 The deductions allowable under s. 73 are thus in some respects wider than those that might be allowable under s. 51(1), though they are in some other respects narrower. Where they are narrower, the question is raised whether s. 73 excludes deductibility under s. 51(1). An argument might be made that s. 73 is a code intended to displace the operation of s. 51(1). Making such an argument would entail defining the area of the code and, having regard to the variety of circumstances with which the section deals, this might be difficult. The assumption is made in what follows that a taxpayer may claim a deduction under s. 51(1) notwithstanding that the circumstances would attract some deduction under s. 73.

6.256 It would appear from *Gordon* (1930) 43 C.L.R. 456 that where the question is the applicability of s. 51(1) the relevance of a subscription to an association to a process of income derivation by a taxpayer is to be judged in the light of the activities of the association. Those activities do not directly determine deductibility as they do under s. 73(2), but they “[tend] to show the purposes for which the taxpayer laid out his money in paying the subscription” (at 464, per Dixon J.). In *Gordon* a deduction was claimed for a subscription to the Graziers' Association of N.S.W. It was claimed under a general deduction section more restrictive than the present s. 51(1). The deduction was allowed. Dixon J., whose decision was upheld on appeal, said (at 462):

“The Graziers' Association of N.S.W. performs for the appellant important work which arises in the conduct of his business, and affords him assistance in carrying it on. It also attempts to promote and protect the general interest of the business of grazier and pastoralist, industrially, commercially and financially. In doing so it extends its activity or its influence into politics, but without confusing or impairing the performance of its main functions, namely, the service of its members in their occupation where combination is effective, and the promotion of their business advantage. I think the subscription was paid to secure those advantages to the business by which assessable income was earned, and for no other purpose or reason, and that it was money wholly and exclusively expended for the production of assessable income.”
The reference to extending “its activity or its influence into politics” may suggest that an association may support financially, or promote or oppose, a political party without impairing the deductibility of subscriptions paid to it by its members. The financial support, and promotion or opposition, would need to be in relation to the business or employment interests of members. If the Association incurs expenses in the furtherance of political objects which are unrelated to the business or employment interests of members, deductibility of subscriptions by its members must be affected. The consequence under the general deduction section with which Gordon was concerned may have been a denial of a deduction for the subscription. Under s. 51(1) an apportionment may be proper, so as to deny deduction of only part of the subscription—the part referable to a purpose insufficiently connected with a process of income derivation to be relevant. That part and the part referable might have been the subject of distinct payments to serve each purpose. In fact the Association in Gordon provided in its rules for the furtherance of political objects, but any money applied in the furtherance of political objects had to be made from a separate fund to which members were not compelled to contribute. The taxpayer in Gordon had in fact made a contribution to this fund, but the deductibility of that contribution was not in question in the case.

6.257 The distinction between extending “activity or influence into politics but without confusing or impairing the performance of [the] main objects” of an association, and engaging in the furtherance of political objects unrelated to the business or employment interests of its members, may not be easily drawn. Two United Kingdom cases may assist: Morgan v. Tate & Lyle Ltd [1955] A.C. 21 and I.R.C. v. Kramat Pulai Ltd [1953] 1 W.L.R. 1332. In the first case deduction was allowed of the expenses of a campaign to prevent the nationalisation of the company's business. The directors of the company had formed the view that the nationalisation of the sugar refining industry in which the company was engaged, would become part of the Labor Party's considered official programme. The authority of the decision on the question whether the expense was working or capital is doubtful in Australia: this aspect is considered in [7.66] below. But the decision may afford an illustration of a relevant expense, at least if it is assumed that the nationalisation feared was a nationalisation by acquisition of businesses as distinct from acquisition of shares in companies conducting those businesses. In I.R.C. v. Kramat Pulai deduction was denied of the expenses of printing, publishing and circulating the remarks of the Chairman at a meeting of a company. The remarks “were an attack throughout the whole of it upon the policy and acts of the Socialist Government which was in office after 1945 and still in
office at the time of the annual meeting in question”. The conclusion, expressed in the analysis adopted in this Volume, that the expenses were not relevant, would be likely in similar circumstances in Australia. *I.R.C. v. Kramat Pulai* was decided, like *Gordon*, in relation to a general deduction provision by which an expense was deductible only if “wholly and exclusively” incurred in a process of income derivation. Section 51(1) allows of an apportionment if some part of the outgoing is relevant. An outgoing may have two purposes each of which might have been separately served, the one giving relevance and the other not. In facts such as *I.R.C. v. Kramat Pulai* it is conceivable that the remarks were in some part expressly directed at acts of the Government which would have special implications for the company, like the nationalisation of the sugar industry in *Morgan v. Tate & Lyle*. There might then, in Australia, be grounds for an apportionment, though the operation of the words “to the extent to which” in s. 51(1) in this context is not evident. The view of this Volume would be that the operation of the words is limited to circumstances which, by objective inference, disclose two distinct purposes each of which could be separately served, the one giving relevance, the other not. The publication of words generally supporting a political party or generally criticising a party, show only one purpose, or two purposes each of which could not be separately served, though the taxpayer may have had reason to believe that success of one party or failure of another would have favoured his business operations or his employment conditions in a special way. The publication must be judged for relevance by degree of connection, and an inadequacy of connection of the expense as a whole is not to be expressed by treating some of the expense as relevant and some not. On this analysis, a simple contribution to the funds of a political party will not give rise to any deduction under s. 51(1). It is an expression of general support, and does not yield an objective inference of purpose which will justify a finding of a connection sufficient to make the expense relevant.

6.258 The discussion of *Morgan v. Tate & Lyle* and *I.R.C. v. Kramat Pulai* concerns deductibility of expenses of promoting or opposing the objectives of a political party, or expenses which are contributions to the funds of a party, where the expenses are directly incurred by the taxpayer. Where the question is the deductibility of a subscription to an association which incurs such expenses, deduction may be sought under s. 73(2) rather than s. 51(1). Section 73(2) links deductibility of the taxpayer's subscription with deductibility to the taxpayer of the expenses incurred by the association had they been incurred by the taxpayer. Section 51(1), at least in the view of Dixon J. in *Gordon* (1930) 43 C.L.R. 456, does not proceed in this way. Dixon J. said (at 463):
“It was suggested on behalf of the Crown that an investigation should be made to ascertain how much of the subscription had been applied in the hands of the Association to purposes conducive to the production of the appellant's assessable income, and Lochgelly Iron and Coal Co. v. Crawford (1913) S.C. 810; 50 Sc.L.R. 597; 6 Tax Cas. 267 and Grahamstown Iron Co. v. Crawford (1915) S.C. 536; 52 Sc.L.R. 385; 7 Tax Cas. 25 were cited. These cases appear to be considered authority for the position that upon a claim to deduct a subscription to a trade society so much, and so much only, is allowable as is proportionate to the expenditure which the society has actually made towards increasing the taxpayer's profits (see Konstam on the Law of Income Tax, 4th ed., p. 146). Probably the course which the first of these cases took was due entirely to the footing upon which it was conducted by counsel. The second, in the result, decides no more than that, before the deduction is allowed, the subjects upon which the society expends its funds should be known. Some of the observations made by Lord Strathclyde and Lord Johnston do suggest that they considered a dissection of the societies' expenditure might be proper in order to determine what portion of the subscription was allowable. I should have thought that the subscription was an entire sum which either was or was not wholly and exclusively laid out and expended by the taxpayer for the purpose of his trade or for the production of income, and that why the manner in which the society expended its funds was relevant to this question was because it showed or tended to show the purposes for which the taxpayer laid out his money in paying the subscription.”

6.259 The interpretation of Lochgelly Iron & Coal Co. and Grahamstown Iron Co., apparently adopted by the Commissioner in Gordon, is now reflected in s. 73(2), but it is not appropriate in expressing the operation of s. 51(1). The manner in which the association expends its funds is no more than a basis of inference as to the purposes for which the taxpayer laid out his money in paying the subscription. The circumstances may show two purposes in the actions of the association in promoting or opposing the objectives of a political party. It does not follow that there are two purposes in the payment of the subscription so that an apportionment may be made and a deduction allowed of so much of the subscription as is moved by a purpose that gives relevance.

6.260 Section 73(2) requires that one look at all the expenses incurred by the association. If any of them is an expense that would have been deductible by the taxpayer if he had incurred a like expense himself, the taxpayer's contribution to the association will be deductible subject to a limit of $42. Alternatively, so much of his contribution as has been or will be applied by the association in meeting the expenses will be deductible, if it is not a capital expense, and if this amount is greater than $42. There are clearly problems in satisfying the hypothesis that the expense would have been deductible by the taxpayer had he incurred it himself. Presumably, one must look to all the circumstances in which the association incurred
the expense, including the time of incurring, and attribute them to the taxpayer. The question then becomes whether an objective inference of a purpose of the taxpayer that would give relevance can then be drawn. There will be occasions when the circumstances attributed to the taxpayer are not enough to yield any objective inference of purpose. Thus the expense of subsidising the provision of some facility available to the taxpayer would be deductible by the taxpayer only if he had incurred the like expense in particular circumstances that gave it relevance to his income earning activity.

6.261 Deductibility under both s. 73(2) and under s. 51(1) is affected by s. 51AB. Section 51AB, which overrides any other provision of the Act, denies deduction of an outgoing incurred to secure for the taxpayer or any other person membership of an association, or rights to enjoy, otherwise than as a member, facilities provided by an association for the use or benefit of its members (subss (3) and (4) of s. 51AB). The section applies where the association was established, or is carried on, solely or principally for the purpose of providing facilities for the use or benefit of its members, in relation to drinking, dining, recreation, entertainment, amusement or sport: s. 51AB(1) (definition of club) and s. 51AB(4). The operation of the section is subject to exceptions which depend on the definition of “excepted facility” in s. 51AB (1). The requirement that the association must have been established or be carried on solely or principally for the purpose of providing facilities will leave s. 73(2) and s. 51(1) to operate where the provision of facilities is a subordinate part of the association's activities.

6.262 The payment of a periodical subscription, if it is relevant, will ordinarily be a working expense, but it is not necessarily so. The payment of a subscription that relates to actions to be undertaken by the association, including the provision by it of services to its members, over a number of years may be seen as securing a lasting benefit such as to make the subscription a capital outgoing. B.P. Australia Ltd (1965) 112 C.L.R. 386 and Strick v. Regent Oil Ltd [1966] A.C. 295 have a bearing. The advantage secured by the payment of the subscription, like the advantage in Ilbery (1981) 81 A.T.C. 4234; 81 A.T.C. 4661, may be one that could be used other than in a process of income derivation, though there is a current use which gives the subscription its relevance. A subscription for life membership of an association may afford advantages which will extend to a time when any process of income derivation to which it is relevant has ceased. The advantage may be dining, accommodation and social facilities. The subscription is not working. A subscription for 3 years' membership is likely to be regarded in the same way. And the possibility of advantage
enuring after the cessation of the process of income derivation may justify a conclusion that the expense is not working when the period of membership secured by the subscription extends to any significant degree beyond the year of income in which it is paid. A parallel conclusion in relation to interest in advance is suggested above ([6.117]–[6.131]) in the discussion of Ilbery. Indeed, in both the subscription and interest situations, the prospect of the advantage enuring after the cessation of the process of income derivation may push the analysis a stage further back, so that the relevance of the subscription or interest is denied.

6.263 The payment of a periodical subscription in respect of a person's membership of any trade, business or professional association is deductible under s. 73(3), subject to a limit in respect of a subscription to any one association, in the year of income, of $42. Section 73(3) does not exclude deductibility of any amount under s. 51(1), s. 73(2) or s. 73(1). Section 73(1) allows a deduction of a periodical subscription in respect of membership of an association where the carrying on of a business by a taxpayer from which assessable income is derived is conditional upon membership of that association. Section 73(1) and 73(3) do not exclude from deductibility subscriptions that would be non-working when judged by s. 51(1) provided they are “periodical”. Periodical is not defined. Nor do they attract the principles of contemporaneity and relevance. Thus a periodical subscription to a professional association is deductible under s. 73(3) though the taxpayer does not practise the profession.

6.264 The assumption in the discussion so far has been that the subscription to the association is of the nature of the subscription in Gordon (1930) 43 C.L.R. 456. A return of any surplus of the subscription, or the making of other payment to a member is not contemplated. The mutuality principle (considered in [2.45]ff. above) will apply to the receipts by the association, so that it does not derive income. Where the rules of the association provide for a return of surplus or other payment to a member, there will be prospects of a denial that the mutuality principle is available to the association, and implications for the deductibility of the subscription. There is a prospect of denial of mutuality because the principles of identity and proportion in relation to the return of surplus are not satisfied, or because the association is an Assessment Act co-operative or an insurance association.

6.265 A possible denial of deductibility where the payment to the association is for the supply to the taxpayer of goods or services is the subject of some observations in [2.84] above. Where the payment to the association is a payment for insurance, deductibility will depend on the operation of principles examined in [6.210]–[6.241] above. In this context,
a distinction was drawn between a premium paid for insurance against misfortune, which will be deductible if it is relevant, and a premium for insurance which will provide the taxpayer with funds to meet an expense which is a normal experience in carrying on a business. On the authority of Ransburg Aust. Pty Ltd (1980) 80 A.T.C. 4114 a premium paid in the latter circumstances is not a working expense. There are two United Kingdom decisions denying deductions for subscriptions to trade associations which are not easily explained. They are Rhymney Iron Co. Ltd v. Fowler [1896] 2 Q.B. 79 and Thomas Merthyr Colliery Co. Ltd v. Davis [1933] 1 K.B. 349. In each case deduction was denied of a payment to a trade association in respect of an indemnity in the event of deficiency or stoppage of output caused by strikes. In the latter case, it was conceded that a premium for fire insurance on business assets was deductible (Usher's Wiltshire Brewery Ltd v. Bruce [1915] A.C. 433) and that a contribution to an association to cover liability to make workmen's compensation payments was deductible. However, following the earlier case, deduction was denied of contributions for an indemnity against deficiency or failure of output owing to strikes. The reason given for denying this deduction is that the payments had been made “to supply a deficiency at a time when there is no trade being carried on” ([1933] 1 K.B. 349 at 371 per Lord Hanworth M.R.). The reason is not persuasive. The reason that explains Ransburg would have been more persuasive, though it might have been difficult to fit the precise facts of the case into the mould of investment and the return of money invested. Subscriptions by an employee to a trade union that entitle him to pay from the union in the event of a strike could, it is thought, be properly denied deduction under s. 51(1) on the authority of Ransburg.

6.266 A final matter concerns the test of relevance where subscriptions are paid by an employee. There might be drawn from the judgment of Menzies J. in Hatchett (1971) 125 C.L.R. 494 a rule that an expense incurred by an employee is only relevant if he is required to incur it by the terms of his employment or if it has a direct effect on income. The rule would involve the conclusion that subscriptions by an employee to a trade union will only be deductible under s. 51(1) if union membership is required by the terms of his employment. Which may indicate that the rule is an unsatisfactory expression of the principles underlying s. 51(1).

The Characterisation of Payments in Commutation of Future Payments or which Relieve from or Reduce Future Payments

6.267 One of the submissions made by the taxpayer in Ilbery (1981) 81 A.T.C. 4661 asserted a rule that an expense which relieves the taxpayer of
a liability to make payments in the future which would be deductible, is itself deductible. *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290—involving a payment by a company to secure a release from a contract with a managing director—and the United Kingdom decision in *Anglo-Persian Oil Co. Ltd v. Dale* [1932] 1 K.B. 124—involving a payment to secure a release from a contract with an agent of the taxpayer—were cited to support such a rule. The point was made above, in discussing *Ilbery* (1981) 81 A.T.C. 4661, that even if such a rule is accepted it has no application to *Ilbery* facts. The payment in *Ilbery* secured a lasting advantage—the use of the money borrowed at no interest or at reduced interest. The payment was not a working expense. And the payment in *Ilbery* could not be said to relieve against payments in the future that would be deductible. It may be correct to say that payments of salary to a managing director to be made in the future (*Nevill*), or payments of commission to an agent (*Anglo-Persian Oil v. Dale*), are payments that would be deductible. But one cannot say that payments of interest to be made in the future are payments that would be deductible, so long as it is accepted that the deductibility of payments of interest depends on the money borrowed being currently laid out in a process of income derivation. The facts of *Nevill* would need to be substantially different if any parallels with the facts in *Ilbery* were to be found. If a taxpayer who is a sole trader pays salary in advance to an employee currently employed in the trader's business or in the trader's private affairs, some parallels may be seen. The analysis and conclusion in regard to deductibility of the advance payment of salary might then follow the analysis and conclusion in relation to the *Ilbery* facts put forward in [6.117]–[6.181] above. If the contract is to serve for a substantial period and the advance payment covers the whole of that period, the payment may be denied deduction as a non-working and thus capital expense. This is to assume that the payment is relevant. The payment can, however, be denied deduction as not relevant. It relates to an advantage which is not necessarily a business advantage: it may at the choice of the taxpayer, be used in affairs which do not involve any process of income derivation. The connection between the payment and the continuing derivation of income from the business is tenuous.

6.268 The asserted rule that an expense, which relieves the taxpayer of a liability to make payments in the future which would be deductible, is itself deductible, requires examination. The rule may explain the deductibility of a payment to commute a pension being paid by a former employer to his retired employee. Its value in this context is considered in [6.272] below. But the rule is simply unacceptable as an expression of s. 51(1) in other contexts, more especially in the context of facts such as were involved in
Nevill and Anglo-Persian Oil v. Dale. In B. W. Noble Ltd v. I.R.C. [1927] 1 K.B. 719 where the facts are close to the facts in Nevill, deductibility is explained on the basis that “in the ordinary case a payment to get rid of a servant, when it was not expedient to keep him in the interests of the trade, would be a deductible expense” (at 726, per Rowlatt J.). Such a payment is relevant, and it will be a working expense unless the employee has by his contract such a command of the conduct of a business that his contract is an aspect of structure. Nevill does not support the asserted rule. The Commissioner in that case submitted a negative rule that contradicted the asserted rule. His submission was that a payment which secures relief from future expenses is not deductible because it does not increase assessable income. The court rejected the submission, thereby rejecting a “blast from the whistle” ([5.34] above) relationship between expense and income derivation as necessary for deductibility under s. 51(1). But the rejection of this negative rule cannot be taken as an acceptance of the positive rule. The positive rule which the case adopts might be drawn from the judgment of Dixon J. in Nevill (1937) 56 C.L.R. 290 at 306:

“In the present case the payment of a lump sum to secure the retirement of a high executive officer may have been unusual. But it was made for the purpose of organising the staff and as part of the necessary expenses of conducting the business. It was not made for the purpose of acquiring any new plant or for any permanent improvement in the material or immaterial assets of the concern. The purpose was transient and, although not in itself recurrent, it was connected with the ever recurring question of personnel.”

The passage quoted reflects conclusions on the issues of relevance and working character.

6.269 In the concluding part of his judgment Dixon J. dealt with “a different question” arising under the former s. 25(e) which forbade a deduction unless it consisted “of money wholly and exclusively laid out or expended for the production of assessable income”. It was in this connection that he considered the Commissioner's submission and observed (at 307):

“When the expenditure avoided or reduced has been or would be incurred for the production of income, it appears to me that the substituted expenditure comes fairly within the description money exclusively laid out for the production of income.”

The observation bears only on the “different question”. It explains why the expenditure was not excluded. It was not intended to explain why the outgoing was deductible under s. 23(1) (a)—the equivalent, in the earlier legislation, of s. 51(1).

6.270 The asserted rule is not supported by the other case, Anglo-Persian Oil Co. Ltd v. Dale [1932] 1 K.B. 124, to which counsel referred in the trial court. That case may support a rule that a payment to get rid of an
onerous contract may be deductible where the contract is not part of the “fixed capital” of the taxpayer's business (at 144, per Laurence L.J.). The contract to employ an agent to manage the company's business in Persia—was “in no sense . . . part of the fixed capital of the company”. The reference to “fixed capital” is a reference to “structure” in the language adopted in this Volume.

6.271 Any positive rule suggested by B. W. Noble, Nevill and Anglo-Persian Oil should not be definitive. Adopting any rule raises the prospect of defeat for s. 51(1), if the rule comes to attract an extended form approach. A payment made to a managing director, in other respects like the payment in Nevill, may be denied deduction if it is made as an aspect of the closing down of the business operations in which he was employed: Godden v. A. Wilson's Stores (Holdings) Ltd (1962) 40 T.C. 161. And such a payment may be denied deduction where it is a payment made by a company employer to give effect to an agreement between former and present shareholders that the company would buy out the contracts of its executive directors: Overy v. Ashford Dunn & Co. Ltd (1933) 17 T.C. 497, Bassett Enterprise Ltd v. Petty (1938) 21 T.C. 730, James Snook & Co. Ltd v. Blasdale (1952) 33 T.C. 244, Faulconbridge v. Thomas Pinkney & Sons Ltd (1951) 33 T.C. 415, George Peters & Co. Ltd v. Smith (1963) 41 T.C. 264, George J. Smith & Co. v. Furlong [1969] 2 All E.R. 760. The payment which is the result of a bargain made in the transfer of control of the company is not to be described as “connected with the ever recurring question of personnel” (Dixon J. in Nevill (1937) 56 C.L.R. 290 at 306) and may be denied deduction. Indeed there is a prospect that a payment to buy out the contract of an executive director may be denied deduction if a change of control of a company has resulted from a take-over bid and the executive director is bought out in order to make way for a nominee of the new controllers. The question is whether the purpose of the payment was to facilitate the exercise of control by the new controllers or to further the derivation of income by the company.

6.272 Earlier in this discussion a question was reserved about the value of the asserted rule that an expense which relieves the taxpayer of a liability to make payments in the future which would be deductible is itself deductible. The reservation related to the circumstance of a payment to commute a pension being paid by a former employer to his retired employee. In Hancock v. General Reversionary and Investment Co. Ltd [1919] 1 K.B. 25 a payment to purchase an annuity equal in amount to a pension payable to a former employee was held deductible under the United Kingdom legislation. The case links the deductibility of the payment made, in effect to commute the pension payment, with the
deductibility of the pension payments that had been made and those that would have been made. The pension payments may be deductible as payments required by the employment contract and thus as deferred remuneration for services performed in the past, or as payments which, though made voluntarily, will enhance the standing of the taxpayer among continuing employees, and promote their loyalty and efficiency. They may be deductible under s. 78(1) (c). The commutation payment attracts deductibility, however, not because it is by way of commutation of those payments, but because it has the same function as those payments. In that function, it may be connected with the process of income derivation, and is thus relevant. It is “connected with the ever recurring question of personnel”. And it does not relate to structure. The commutation payment has the same character as a lump sum paid in the first instance, instead of the payment of the annuity, would have had.

6.273 Where the pension payments were not and would not be deductible because of their function, the commutation payment will have the like character. Annuity payments by a company to the widow of the former proprietor of the company's business, arising from an obligation undertaken under the contract by which the company acquired that business, are not connected with the process of income derivation by the company and are not relevant. Alternatively they are capital, as payments for the business. A payment by way of commutation is equally irrelevant or capital. It will have the same character as a lump sum payment to the widow, stipulated for in the contract by which the business was acquired, would have had.

The Characterisation of Expenses which relate to the Formation, Powers and Administration of an Entity

6.274 Expenses may be incurred in the organisation or reorganisation of a company, trust or partnership, and in the administration of the entity. The reorganisation may involve amendment to constituent documents. Administration may involve the holding of meetings, and the preparation of accounts and other documents, and the filing of these documents.

6.275 The expenses of organisation—the formation of a company trust or partnership—would generally be assumed to be not deductible, and the expenses of reorganisation and administration to be deductible. These assumptions require examination. The company, partnership or trust is an entity that is a taxpayer, or an entity deemed to be a taxpayer for the purpose of determining the income of others who derive income through that entity. The expenses of formation of an entity, when incurred by the
entity, lack sufficient connection with the derivation of income to be relevant: they are private expenses. Where the expenses are claimed by a person who derives income through the entity—a shareholder, a beneficiary in the trust or a partner—the expenses, if regarded as relevant, will generally be denied deduction as not working: they are capital expenses. Where, however, a taxpayer deals in shares the expenses of formation of a company in which he takes shares may be both relevant and working expenses.

6.276 The expenses of reorganisation so as to extend or restrict the powers of the entity admit of the same analysis as the expenses of formation. *I.R.C. v. Carron Co.* (1968) 45 T.C. 18 does not, however, follow that analysis where the question is deductibility by a company taxpayer. The expenses related to the obtaining of a supplementary charter which relieved the company of a limit on its borrowing powers. The case proceeds on an analysis which would treat the limit on the company's powers in the same way as a limit imposed by some licensing authority—for example a quota restriction on import or production of goods. The expenses of obtaining relief from the restriction in the latter circumstances are clearly relevant, and will be working expenses if the limit is not seen as going to the structure of the company's business. *I.R.C. v. Carron Co.*, in effect, ignores the corporate veil. It treats the restrictions on borrowing not as an aspect of the capacity of the entity to carry on business, but as a restriction on the carrying on of business by the proprietors of that entity. And the case treats a restriction which would affect any activity—business or investment—of the company as if it were a restriction on the particular business activity in which the entity is currently engaged.

6.277 The *I.R.C. v. Carron Co.* analysis might be applied to some expenses of reorganisation of a trust or partnership, though the compromises with principles which insist on the separateness of the entity will be more evident. And the *I.R.C. v. Carron Co.* analysis might be applied to some expenses of administration of the entity. The expenses would be treated not as expenses which concern the personality of the entity—and thus not relevant—but as expenses which concern the carrying on by the entity of its business, or the holding by the entity of property whence income is derived, so that the expenses are relevant and, presumably, working. The expenses associated with the ordinary acts of administration which company law requires of a corporate entity—the preparation and filing of accounts and the making of returns to public authorities—may be illustrations.

6.278 There must, however, be limits on the deductibility that can be supported by *I.R.C. v. Carron Co.* The expenses of a reorganisation which
concerns the rights of shareholders, partners or beneficiaries, are not relevant to any process of income derivation. Expenses associated with the payment of a dividend or the making of a distribution by a trust or partnership are not relevant to any process of income derivation. (Cf. Aiken v. Macdonald's Trustees (1894) 3 T.C. 306.)

6.279 Expenses of the kind now being considered are likely to be paid for the services of a lawyer or an accountant. The character of the expenses as legal or accounting expenses is not in itself significant. The character of an expense that is significant in determining deductibility under s. 51(1) is the function of the payment, not the occupation of the person who receives the payment. Section 64A of the Assessment Act provides for a limited deduction of “legal expenses” as defined. There is a ceiling of $50. In its application to expenses of services of a “barrister or solicitor”, the section is a curious intruder. It appears as a subsidy to the use of the services of a barrister or solicitor. There is a question, however, whether the section has any application in this aspect or in any other. Section 64A(2), the operative provision, borrows from the language of the second limb of s. 51(1) but does not repeat the exclusion of outgoings of a capital nature. The view taken in this Volume is that the exclusion of outgoings of a capital nature in s. 51(1) is stated only by way of contradistinction: it is not a true exception. On this view, s. 64A can have no wider operation than s. 51.

6.280 Whatever the application of the section, there is a question whether assumptions in the drafting of the section in relation to the other expenses with which it is concerned may have some bearing on the present discussion, and on the discussion under immediately following headings. These other expenses are (i) costs of registration of a document on a public register and of the stamping of a document, and (ii) expenses in connection with proceedings before a court, board, commission or similar tribunal. It might be said that the first group of these other expenses, if costs of stamping documents are ignored, will comprise principally expenses that relate to the formation, powers and administration of an entity, and that the assumption is that such expenses may be relevant to a process of income derivation. It was only necessary to overcome the prospect of denial of a deduction under s. 51(1) on the ground that the expenses were not working. It may be doubted that there is any such assumption in the subsection, more especially because of the inclusion of costs of stamping in the first group of expenses.

6.281 The assumption that may be drawn from the second group of expenses, and its implications, are considered under immediately following headings.
The characterisation of expenses of collecting and recording receipts which involve the derivation of income, and of payments of taxes

6.282 The expenses now considered are distinguishable from the expenses of administration of an entity that is the taxpayer in relation to which a calculation of deductible expenses is made. The expenses of administration of an entity may be incurred even though the entity is not engaged in any process of income derivation. The expenses of collecting and recording income are incurred in the very process of deriving income, or they are an immediate consequence of derivation of income.

6.283 A “blast from the whistle” test ([5.34] above) of the relevance of expenses to the derivation of income would involve the denial of the deductibility of expenses of collection and recording income. The income cannot be said to have been produced by the expenses, within a meaning of “produced” which is expressed in the blast from the whistle metaphor. Such a notion of “produced” has not however been established in any rule expressing the requirement of relevance for purposes of s. 51(1). One of the arguments for the Commissioner in Charles Moore & Co. (W.A.) Pty Ltd (1956) 95 C.L.R. 344 assumed such a notion. It was argued that a loss of money whose receipt is a derivation of income is not relevant to the gaining or producing of income, since any derivation of income to which it relates has already occurred. The argument was expressly rejected by the High Court in holding that the loss was a deductible expense.

6.284 Relevance is a matter of sufficient connection. There may be such where the expense is inherent in the process of deriving income, or is an immediate consequence of its derivation. A commission paid by a taxpayer to an agent who collects receipts which involve a derivation of income by the taxpayer is deductible under s. 51(1). Section 64 provides specifically that “expenditure incurred by the taxpayer in the year of income by way of commission for collecting his assessable income shall be an allowable deduction”. The section is drafted in language that is conceptually unsound: it assumes that the quality of income attaches to what is received, not to the act of receipt. Similar language used in s. 71 was the subject of comment in [6.70] above. But the section is no more than declaratory of a deductibility in any event given by s. 51(1). The commission paid to an agent has its parallels in some expenses involved in actions to obtain receipts, taken by the taxpayer himself. Travelling expenses of the taxpayer, the travel being undertaken for the purpose of collecting receipts, are deductible. Expenses incurred in suing for the recovery of amounts receivable are deductible.

6.285 Expenses of collecting receipts, paid in respect of another's actions
or in respect of the taxpayer's own actions, will be deductible whether the
derivation of income is in the arising of the right to receive, an accruals
basis of tax accounting being applicable, or in the actual receipt, a cash
basis of tax accounting being applicable. There is no basis for drawing a
distinction which may allow a deduction to a taxpayer engaged in business,
but deny it to a taxpayer who derives income from property.

6.286 Expenses of recording receipts and of verifying the recording are
deductible. There is no basis for attempting to distinguish collection from
recording, so as to deny deduction to the latter. In Green (1950) 81 C.L.R.
313 the taxpayer's income included director's fees, rents, dividends and
interest on mortgages. He claimed and was allowed deductions for (i) fees
for keeping books, and audit fees paid to an accountant; (ii) a salary paid to
his daughter for her services in acting as a clerk in attending to his
financial affairs; and (iii) expenses of travelling from Brisbane to
Townsville and Cairns to inspect and supervise the properties whence he
derived income in the form of rents. The High Court held all these
expenses were deductible. The court said (at 319):

"His Honour found that it was reasonably necessary for the taxpayer to keep books
and records and to have them audited and to have a person in attendance in Brisbane
to deal with matters affecting his financial affairs which arose during his absence
from Brisbane, and his Honour held that it was reasonably necessary to inspect and
supervise from time to time the properties from which rents were derived. The
evidence supported these findings. The expenditure, a deduction of which is
claimed, was incurred in relation to the management of the income-producing
enterprises of the taxpayer. If this is so it is immaterial that there might be a
difficulty in holding that the taxpayer was carrying on in a continuous manner an
identifiable business of some particular description."

6.287 There is another observation in the judgment that may be noted.
Attention is drawn to the fact that only part of the travelling expenses were
claimed, and it is then observed (at 319):

"Accordingly, in so far as any part of this latter expenditure could be regarded as
devoted to a capital purpose in the protection of the reversion of the taxpayer in
these properties, allowance has been made for that matter by the learned judge."

It would be accepted that expenses of travel to negotiate a new lease are not working
expenses. Such an assumption underlies the express provisions in s. 68, providing for
deduction of expenses relating to lease documents. But expenses of travel to inspect
the state of repair of premises and to give instructions for repairs, should be regarded
as maintenance expenses and thus working. There is none the less a question of their
relevance. Green was decided some years before Lunney (1958) 100 C.L.R. 478 in
which it was held that expenses of travel between home and a place of work of an
employee, or a person engaged in a business, is not deductible. The expenses are not
deductible because they are a consequence of the taxpayer's choice of a place in which
to live. It would seem to follow that expenses of travel between home and a place 
where property is held from which income is derived, are not deductible. They are 
equally a consequence of a choice by the taxpayer of a place in which to live. The 
conclusion that the travel expenses in Green were deductible might be saved by 
distinguishing Lunney. Where a taxpayer has a place of business in the city in which 
he lives and may be said to have travelled to and from that place of business when he 
travels to inspect the property in which he has invested, he may be entitled to a 
deduction of travel expenses on the authority of Pook v. Owen [1970] A.C. 244. And 
Lunney might be distinguished on another basis. Where a taxpayer has investments in 
a number of places away from his home, it is arguable that the expenses of travel arise 
not from his choice of a place as his home but from the choice of places of 
investment. An argument of that kind had the support of Brightman J. in Horton v. 
Young [1972] Ch. 157 in reference to the circumstances of a chimney sweep who 
leaves home each morning and goes from house to house sweeping chimneys. A more 
likely illustration would refer to a building worker. A building worker's situation is 
however different from that of the taxpayer in Green, in that he has shifting places of 
work. The taxpayer in Green had fixed places of investment. Lunney, Pook v. Owen 
and Horton v. Young are discussed in [8.61]ff. below.

6.288 In Green, deduction was denied by the trial Judge of a part of the 
travelling expenses on the ground that some of those expenses related to a 
capital purpose—the negotiation of a new lease. The view taken in this 
Volume would be that an apportionment is not available under s. 51(1) in 
such circumstances. The purpose in the travel that was a non-working 
purpose could not have been served by a distinct payment. A 
characterisation as relevant and working should be made in relation to the 
expense as a whole. In [8.16], [8.51] and [8.85] below it is argued that one 
cannot express a doubt about relevance by making an apportionment and 
allowing a deduction of part of an amount. It might equally be argued that 
one cannot express a doubt about the working character of an expense by 
making an apportionment and allowing a deduction of part of an expense. 
An apportionment is only proper where there is more than one purpose 
served by an expense and each purpose could have been served by a 
distinct payment. These questions are further considered in Chapter 9 
below.

6.289 The view taken in the preceding paragraphs is that expenses of 
collecting receipts which are income, and the expenses of recording and 
verifying those receipts, are working expenses and deductible. There is 
none the less an argument to be made that the expenses of distribution by 
an entity of moneys it has received, among shareholders, beneficiaries or 
partners, are not deductible. The expenses are not connected, save 
historically, with any process of income derivation by the entity whose 
actual or notional taxable income has been calculated. If the expenses are 
incurred by the shareholder, beneficiary or partner, they may be relevant 
and deductible as expenses of collecting income. In the case of a
partnership, where any expenses will have been incurred by the partnership as agent for the partners, there may be room for allowing a deduction to a partner of the expenses, as expenses of collecting income. But, where the expenses have been incurred by a company or a trust, it will not be possible to regard them as incurred by the shareholder or beneficiary.

6.290 Some support for the view that expenses of making a distribution of income are not deductible may be found in the United Kingdom decision in *Aikin v. Macdonald's Trustees* (1894) 3 T.C. 306. A deduction was sought by a trust, against income from a foreign source received in the United Kingdom, of an amount being “the average annual expenses incurred in the United Kingdom in connection with the management of the trust”. The denial of the deduction is in some conflict with the view taken above that the expenses of recording and verifying the receipt of income are deductible. So far however as the denial related to the expenses of distribution of trust income, it may be accepted as consistent with the Australian law. The expenses are simply not relevant, and admit of the description “private or domestic”—a description thought appropriate by Lords Adam and McLaren in *Aikin v. Macdonald's Trustees*.

**Expenses, being payments of taxes and expenses related thereto**

6.291 Distinctions need to be drawn between taxes on income and other taxes, and, in relation to the former, between the Australian income tax and a foreign income tax. And a distinction may be necessary between an expense which is the payment of the tax, and an expense which is related to that payment. It would be generally assumed that tax under the Assessment Act is not deductible in determining the taxable income on which tax is levied. There is no Australian judicial authority, but decisions in relation to the United Kingdom income tax may be persuasive. The principal United Kingdom authority is *Smith's Potato Crisps (1929) Ltd v. I.R.C.* [1948] A.C. 508. The case concerned the deductibility of expenses of an appeal against an income tax assessment, not the deductibility of the tax itself. None the less the conclusion denying deductibility of the expenses of the appeal must, a fortiori, apply to the expense of paying the tax. Lord Porter said (at 520-1):

“It is true that as a matter of convenience the cost of making up accounts for the Inland Revenue is allowed by the authorities as a deduction from profits, as is the cost of making up the strictly business accounts of the trade, but this is not a matter of principle but of expediency. The two duties overlap and in practice are almost indivisible. Moreover it is of advantage to the Revenue to have the figures required for their purposes carefully and accurately made up. Strictly, however, I think the expenses should be divided and any additional cost of making up revenue accounts
should be disallowed in determining the allowable deduction for income tax purposes, but the advantages of allowing both to be deducted as a practical measure outweigh the disadvantages, though the result may not be strictly logical. But no such illogicality has to be faced when the sum which is alleged to be deductible is not the cost of accountants' work in ascertaining trading profits, but the expense of an appeal to the Board of Referees for the purpose of discovering the true measure of profits for tax purposes only. Such expenditure is incurred directly for tax purposes and for nothing else, though it may indirectly affect both the amount available for distribution to the proprietors of the business and that proper to be put to reserve.”

The observations are significant in their recognition of the deductibility of expenses of recording and verifying income discussed under the last heading. They are also significant in their assertion that the expenses of preparing “revenue accounts” should not be deductible. It would follow, logically, that the expenses of resisting an assessment and, a fortiori, the expense of the payment of an assessment are not deductible. The reason for the denial of a deduction of expenses of preparing an income tax return, of disputing an assessment and the payment of an assessment, may not however be adequately expressed in saying that the expense is “incurred directly for tax purposes and for nothing else”. A more adequate statement of reason may be found in the judgment of Lord Normand (at 529–530):

“...The reason why income tax is not deductible in computing profits for income tax purposes is not merely the logical difficulty pointed out by [counsel] that, if it were, the computation would inevitably drift through the repetition of the deduction into the eddy of an indefinite process. There is the more substantial reason, that income tax is an impost made upon profits after they have been earned, and that unless the observations of Lord Davey in Strong & Co. of Romsey Ltd v. Woodfield [1906] A.C. 448 at 453, which have often been referred to and applied in later cases, are to be disregarded a payment out of profits after they have been earned is not within the purposes of the trade carried on by the taxpayer.”

The distinction between an outgoing in gaining income, and an outgoing which is an application of income gained, is drawn in other contexts and is the subject of further examination in [6.301]–[6.307] below. The distinction is not between an outgoing that “produces” income and an outgoing which does not. Any such distinction was rejected in Charles Moore & Co. (W.A.) Pty Ltd (1956) 95 C.L.R. 344 and in W. Nevill & Co. Ltd (1937) 56 C.L.R. 290. An outgoing which does not in any literal sense produce, may yet be an outgoing “in gaining”. But an expense must have more than an historical connection with the derivation of income. It must be connected with the process of derivation of income.

6.292 The judgment in Green (1950) 81 C.L.R. 313 at 319 includes the observation that “we are not to be taken as deciding whether or not the cost of preparing taxation returns or of advising in relation to taxation liability is a deductible expenditure”. The express provision in s. 69 of the Assessment Act, in allowing a deduction of certain expenses in preparing an income tax return, proceeds on an assumption that such expenses would not otherwise be deductible. There must of course be problems in making
the separation, referred to by Lord Porter in *Smith's Potato Crisps (1929) Ltd*, between the expenses of recording income and the expenses of preparing a return, but where that distinction can be drawn expenses of preparing a return which are not within s. 69 will not be deductible. Some inference may be drawn from the provision of s. 64A, allowing a very limited deduction for expenses in connection with “proceedings before a court, board, commission or similar tribunal”, that expenses of disputing an income tax assessment are not deductible under s. 51(1).

6.293 Where the Australian income tax paid is withholding tax, there is an added reason why the tax is not deductible. Section 128D provides that “income upon which withholding tax is payable . . . shall not be included in the assessable income of a person”. If the withholding tax is seen as incurred in gaining income, it will yet fail to qualify as deductible under s. 51(1) because its relevance is to income which is not assessable income.

6.294 The conclusions here reached in regard to Australian income tax are not necessarily valid where the question raised is the deductibility of a foreign income tax. Where foreign income tax has been paid on income derived from a foreign source by an Australian resident, the income will generally be exempt from Australian tax under s. 23(q), and any question of deductibility of the foreign tax is sufficiently answered by pointing to this exemption—the foreign tax is not an expense relevant to the gaining of assessable income. In some circumstances s. 23(q) does not confer an exemption—where the income is dividends, or is interest or royalties and the foreign tax is subject to a limit on its amount provided for in a double tax agreement. Where it does not, the problem of deductibility is generally precluded by express provisions allowing a credit for the foreign tax, provisions which are inconsistent with deductibility of the foreign tax.

6.295 The question of deductibility of a foreign income tax may, however, arise where Australian source income of a non-resident that is subject to Australian tax is also subject to income tax in the country of the taxpayer's residence. The United Kingdom decision in *I.R.C. v. Dowdall, O'Mahoney & Co. Ltd* [1952] A.C. 401 involved circumstances of this kind. The House of Lords applied its own decision in *Smith's Potato Crisps (1929) Ltd*, referred to above, in denying a deduction. Lord Oaksey said (at 409):

“On the first question I am of opinion that taxes such as those now in question, namely, income tax, corporation profits tax and excess profits tax, are not according to the authorities wholly and exclusively laid out for the purposes of the company's trade in the United Kingdom. Taxes such as these are not paid for the purpose of earning the profits of the trade: they are the application of those profits when made and not the less so that they are exacted by a dominion or foreign government. No clear distinction in point of principle was suggested to your Lordships between such
taxes imposed by the United Kingdom government and those imposed by dominion or foreign governments.”

There is, of course, a logical difficulty in transferring the reasoning in *Smith’s Potato Crisps* to a foreign income tax. The foreign tax will follow its own law as to how income subject to tax is to be calculated, and the idea of an application of income derived, can only be sustained if the use of the same word is assumed to give an identity to the foreign and the Australian tax. And yet the very notion of an application of income derived assumes an identity between net income as it may be calculated in the taxpayer's own accounting for profit, and taxable income as it is determined for tax purposes. Ultimately an application may be made only of the assets which may be traced to derivations which go to the determination of the taxpayer's profit. They cannot be made out of the profits themselves. We may gloss over this difficulty and the further difficulty of regarding a payment as an application of taxable income. And it is then a short step in false logic to say that payment of a foreign tax is an application of Australian taxable income, where the base of the foreign tax has been calculated in the manner of the Australian income tax. In fact, the “application of income” notion is no more than a way of expressing the converse of what in more general principle is a test of relevance which requires that the expense be incurred in the process of deriving income.

6.296 The observation in the last paragraph provides an opportunity to debate the nature and relevance of an asserted fundamental distinction between the United Kingdom and the Australian income tax. The distinction is regularly asserted in judicial pronouncements, most recently in the judgment of Gibbs C.J. and Mason J. in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 as an explanation of differences between United Kingdom and Australian law. It is said that, at least when the income is that of a trader, the United Kingdom income tax imposes tax on “profits”, while the Australian law imposes tax on taxable income, the assumption being that the United Kingdom profits are, in some sense, the “real” profits—profits as commercial men see them. The Australian income tax, on the other hand, imposes tax on taxable income—profits, if the word is appropriate at all, as the law determines. It should be clear from the distinction drawn by Lord Porter in *Smith’s Potato Crisps* (1929) Ltd (quoted in [6.29] above) between “business accounts” and “revenue accounts” that the distinction drawn in the judicial pronouncements in Australia is without foundation. It is true that Schedule D Case 1 of the United Kingdom *Income and Corporation Taxes Act* 1970 purports to tax the “profits of a trade”. But the “profits of a trade” are determined by
statutory provisions and a wealth of judicial decisions as to what are profits, the judicial decisions expressing a concept of income which provides virtually the whole of the original and continuing inspiration of the Australian notion of income by ordinary usage. From profits the United Kingdom law allows a deduction only of expenses “wholly and exclusively laid out for the purposes of the trade”. It is true that the relevant provision of the United Kingdom law is expressed in a negative, denying a deduction of expenses not wholly and exclusively laid out for the purposes of the trade. But a positive test of deductibility has been inferred from the negative, and the approach of the United Kingdom income tax has come to be indistinguishable from the approach that is directed by the express terms of s. 51(1) of the Australian Assessment Act. Again the United Kingdom judicial decisions interpreting the test of “laid out for the purposes of the trade” are a large part of the original and continuing inspiration of the Australian principles of deductibility.

6.297 The conclusion is that there is no substance in the asserted fundamental distinction, and that the United Kingdom cases on the deductibility of income tax paid, if sound in the United Kingdom context, are sound in the Australian context.

6.298 A foreign tax will not be deductible, by whatever name it is called, if its function, like the function of the Australian income tax, is to tax accretions to economic power. But other taxes may fairly be regarded as relevant to the process of income derivation, and working expenses, so as to be deductible under s. 51(1). Sales tax paid by a manufacturer or wholesale merchant, where he sells in the course of his business, is an obvious illustration. Sales tax paid by a manufacturer who takes goods for his own use is an obvious illustration of a tax that is not deductible. Land tax paid by an investor, where the tax relates to property let to produce income, will be deductible. In this instance there is a supporting express provision in s. 72, a section considered in [6.149]–[6.160] above. Payroll tax paid by a taxpayer in respect of salary and wages of persons employed in business will be deductible. Where the taxpayer's activities do not amount to a business, though they involve a process of derivation of income, deductibility of payroll tax will follow deductibility of the salary and wages paid.

6.299 In some instances the relevance of payment of the tax to the derivation of income may not be beyond argument. In Harrods (Buenos Aires) Ltd v. Taylor-Gooby (1964) 41 T.C. 450 the question was whether a United Kingdom company carrying on business in Argentina could deduct an Argentine tax levied on companies carrying on business in that country. The tax was charged at the rate of one per cent on the company's capital,
and was payable whether or not there were profits liable to Argentine income tax. The case for the Revenue was that the payment of tax was made, not in the company's capacity as a trader, but in its “capacity as a taxpayer”. The Court of Appeal rejected the test and relied on the tests of relevance in *Smith's Potato Crisps* examined above, for a conclusion that the tax was deductible. One would have thought that the notion of capacity as a taxpayer and the notion of application of income are indistinguishable. Both express a judgment of insufficient connection—a lack of relevance—to the process of income derivation. The tax in *Harrods* had more than an historical connection with the derivation of income. It was an expense that had to be met in order to sustain its right to carry on business.

6.300 It will have appeared from the preceding discussion that the deductibility of preparing a return for the purposes of a tax, and of disputing any assessment, will follow the deductibility of the tax itself, though there will be difficulty, where the tax is not deductible, in separating the expenses of preparing a return from the expenses of recording the transactions which are reflected in the return.

**The Distinction between Expenses of Deriving Income and the Application of Income Derived**

6.301 The distinction between expenses of deriving income and the application of income derived was the subject of some comment under the last heading ([6.291] above). In that comment, and earlier in [6.70] above, the point was made that the notion of application of income derived is logically unsound. Income is a quality of derivation of an item. It is not a quality of what have been derived. It is more than a quibble to say that the money in one's pay envelope is not income. It may be money that in its derivation was income. If it is ever correct to say that money itself is income—the usage is probably beyond being eradicated—it does not retain that quality for any time. It has that quality only for a moment of time—the moment of derivation.

6.302 To say that the notion of an application of income is logically unsound, is not to dismiss the distinction between an expense of deriving income and an application of income derived as unhelpful in resolving a question of deductibility. In [6.295] above it was suggested that the distinction is helpful in emphasising that an expense to be deductible must be incurred in a process of income derivation. There must be something more than a mere historical connection of the kind that exists where an outgoing has been made, in some sense, out of money which in its derivation was income. The fact that the obligation to make a payment
arose because income had been derived adds a further element of connection but it is not sufficient to make the expense relevant. There is another way of expressing the insufficiency of the connection. A payment to discharge an obligation which arises because of acts done or omitted in the process of deriving income may be sufficiently connected. But a payment to discharge an obligation which arises because a derivation of income has occurred is not sufficiently connected. It is for this reason that a payment of income tax is not deductible in determining income subject to tax.

6.303 In a number of other contexts outgoings have been held not deductible as applications of income derived. The judgment of Lord Davey in Strong & Co. of Romney Ltd v. Woodifield contains a statement that “it is not enough that the disbursement . . . is made out of the profits of the trade. It must be made for the purpose of earning the profits” ([1906] A.C. 448 at 453). As an explanation of why the outgoing—damages paid to a person staying in the taxpayer's inn in respect of injury caused by the fall of a chimney—was not deductible, the statement is not persuasive. It could not be said that the obligation to make the payment was simply a consequence of income having been derived. The explanation of Lord Loreburn L.C. that the obligation to pay damages “fell upon [the taxpayers] in their character not of traders but of householders” at least brings the issue closer to the relevance of the outgoing. Strong v. Woodifield was the subject of comment in [6.51] above. It will be seen from the passage quoted in [6.291] above that Lord Normand in Smith's Potato Crisps (1929) Ltd drew on the statement by Lord Davey to support his conclusion that income tax is not deductible in determining income subject to tax. It is not easy to see what common factor there may be between a payment of damages to an injured guest in a hotel and the payment of income tax.

6.304 More persuasive is the use of the application of income test of relevance in the context of payments by a company to shareholders or to debenture holders. Where a payment is made to a shareholder, qua shareholder, a characterisation as a distribution of profits—an application of income derived—is likely to be compelling. Where however a payment is made to a debenture holder, the payment may be characterised as a payment to service a borrowing and deductible as an outgoing incurred in the process of derivation of income, in the same way as interest is deductible. The leading Australian decision is C. of T. (W.A.) v. Boulder Perseverance (1937) 58 C.L.R. 223. The case concerned a Western Australian Dividend Duties Act and is not directly relevant to the operation of the Assessment Act. The debenture holders were entitled to interest, on the moneys they had lent to the company, at 10 per cent. In addition each
debenture contained a covenant by the company to divide among and pay to the debenture holders, pro rata in proportion to the moneys each had lent to the company, 50 per cent of the profits of the company each year. The deductibility of the payments under the name of interest was not questioned, but deduction was denied of the payments of shares of profits in determining the profits subject to the Western Australian duty. The court (Latham C.J., Dixon J. and McTiernan J.) said:

“... when money is borrowed for use in the business, the reward of the lender in the form of interest is regarded as a necessary or proper deduction for the purpose of ascertaining the profits of the business, and the fact that the reward is made to vary with the success of the business ought not to affect its character as an expenditure incurred for the purpose of earning profit. Yet capital may be invested in a business in order to obtain a share in the profits indistinguishable from that of the proprietor. The solution of the difficulty must in every case be found in determining the point as at which the ascertainment of net profits is required, and this depends upon the purpose for which they are to be computed. . . .

The purpose of the Act is to tax in the hands of companies all profits they make in the State without regard to the manner in which the profits are dealt with. In this view it becomes, we think, immaterial whether the profits are earned by the employment of share capital or debenture capital. It is not denied that the fixed interest charges on debenture capital constitute a prior deduction in the calculation of the “profits made by the company”. Such charges are regarded as an ordinary business expenditure. But, when the debenture contract lets the debenture holder into participation in the “trading profits” over and above his fixed interest charge, it gives his debenture capital an additional characteristic, a characteristic inconsistent with that of a simple external loan by a creditor looking only for security for his capital and a certain regular remuneration for its use. The point at which the Dividend Duties Act, in order that its purpose may be answered, requires that “profits made” shall be ascertained is after deducting all the expenses, including interest on borrowed money, incurred in the course of conducting the business of the company and before the fund of profit is applied to the use of those who have obtained a title to its enjoyment by subscribing share capital or by purchase or otherwise by contract. It may be that the possibility of sharing in profit formed an inducement to the note or debenture holders, but it is the interest at 10 per cent per annum that alone represents the actual compensation for the use in the business of the capital so raised for which a deduction should be made in finding the business profits. The share in the profits appears to us to represent a right to the distribution of the fund finally earned by the business, the taxable fund. . . .

The nature of the contract in the present case appears to be clear enough. The parties adopted a contract for the division between them of the ultimate net profit made by the company. It is more than a payment contingent upon the making of net profits and proportional to their amount. It is a payment of part of the net profits under that description. No doubt Lord Macmillan made too absolute a statement in Pondicherry Railway Co. Ltd v. Commissioner of Income Tax, Madras (1931) L.R.
58 Ind. App. at 251 when he said that ‘a payment out of profits and conditional on profits being earned cannot accurately be described as a payment made to earn profits’. In Indian Radio and Cable Communications Co. Ltd v. Income Tax Commissioner (1937) 3 All E.R. 709 at 713 Lord Maugham said that it might be admitted that it is not universally true to say that a payment the making of which is conditional on profits being made cannot properly be described as an expenditure incurred for the purpose of earning such profits. What is important, however, is the fact that the fund which under the contract the company divides with the debenture or note holders is the fund of profit cleared of all other charges whatsoever, with the contingent exception of the tax or taxes thereon” (at 229–230, 231–2, 234).

The distinction between “a payment contingent upon the making of net profits and proportional to their amount”, which may be deductible, and “a payment of part of the net profits under that description” may be thought verbal only, and the reference to the purpose of the statute, towards the end of the judgment, as not “confined to the taxation of profits that are available to shareholders and no one else” serves no more than to limit the decision in the case to the operation of the particular statute. One would have thought that, consistent with the approach taken in cases which rest on the purpose of the payment, the question of deductibility might have been resolved by asking whether the function of the payment was to service the borrowing or to effect a distribution of profits. A conclusion that it was the latter required a denial of the deduction. A number of United Kingdom cases where the characterisation of the payment as payments made to effect a distribution of profits are referred to in Boulder Perseverance. They reflect a disposition, where the return to a debenture holder is related to the amount of profits earned, to assimilate the positions of the debenture holder and of the shareholder.

6.305 A senior employee of a company may be employed on terms that he is to be paid a share of the profits of the company. In A. W. Walker & Co. v. I.R.C. [1920] 3 K.B. 648, Rowlatt J. distinguished such a payment to an employee from a payment to a debenture holder. The share of profits taken by an employee admits of characterisation as a reward for services and it is possible to confine the application of income principle to payments to persons who have provided share or loan capital, or persons who are, for other reasons, investors. Where the employee is also a shareholder there will be a question whether the payment is made to the employee as employee or as shareholder. Section 109 of the Assessment Act gives the Commissioner a discretion in some circumstances to treat a payment to an employee as a distribution of profits, so that the company is denied a deduction.

6.306 Denial of a deduction as an application of income may have the consequence that what appears to be the same gain is taxed to two taxpayers. Where one of these taxpayers is a company and the other is a debenture holder in that company, the consequence may be thought acceptable so long as the Australian income tax applies the separate system in taxing a company on its profits and a shareholder on distributions he
receives from the company: the position of a debenture holder is assimilated to that of a shareholder. Where the taxpayer making the application of profits is not a company or the application of profits is made by a company to a person who is not a shareholder or debenture holder, or is made to him otherwise than as a shareholder or debenture holder, there would appear to be a prospect of an unacceptable taxing of the same gain to two taxpayers. Where the taxpayers are partners or may be said to be in receipt of income jointly, the provisions of Div. 5 of Pt III avoid two taxes on the same gain. The taxpayers may however be in the kind of relationship that existed between the taxpayer and the bondholders in N.Z. Flax Investments Ltd (1938) 61 C.L.R. 179. The High Court in that case did not have to decide whether the payments the taxpayer had agreed to make to bondholders from the proceeds of sale of flax would be deductible in determining the taxable income of the taxpayer. In Cliffs International Inc. (1979) 142 C.L.R. 140 the taxpayer was allowed a deduction of the payment it made to the persons from whom it had acquired shares, shares which enabled it, in turn, to acquire mining rights. The payments under the agreement with the former shareholders were made on the exercise, and in relation to the exercise, of the mining rights and were probably income of the former shareholders. The High Court held that the payments were deductible. It might, however, have taken a different view if the payments had not been required during the whole life of the mining rights. In Colonial Mutual Life Assurance Society Ltd (1953) 89 C.L.R. 428 the taxpayer was denied a deduction of payments made to another taxpayer who, in Just (1949) 23 A.L.J. 47, had been held to have derived income in the receipt of those payments.

6.307 These illustrations may indicate that it will not always be possible within existing principle to ensure that the same gain is not taxed twice. At the same time, any development of principle towards recognising a policy against taxing twice will open avenues of income shifting which will raise another policy issue. The existing equipment of principle ought to reject the verbal distinction drawn in Boulder Perseverance and that case should be seen as an aberration, reflecting a disposition to treat debenture holders as shareholders when the development of the law in this area should move towards treating shareholders as debenture holders. A company in the situation of New Zealand Flax should be seen as making payments to investors which are maintenance costs of their investments. For the rest, the principles of relevance and working character should determine deductibility as they did in Cliffs International and Just.

The Characterisation of Losses in Relation to Receivables and
Liabilities

The notion of “loss”

6.308 The expenses so far considered in detail have been mostly outgoings. One important exception was an expense arising from the deprivation of an asset which is the taxpayer's own property. In [6.52]ff. above, it was asserted that such an expense is a loss—the failure of an asset to realise its cost—though where the asset is cash in Australian currency the amount of the expense will be the same whether it is seen as an outgoing or as a loss. In the opening treatment of the operation of s. 51 ([5.14]–[5.26] above), the distinction between an outgoing and a loss is discussed, and a number of illustrations given of circumstances in which the relevant expense is a loss. Those illustrations comprise circumstances where a specific profit would have been income if a specific profit had resulted instead of the loss. Most of these circumstances concern the failure of a revenue asset to realise its cost. Some however concern the discharge of a revenue liability—a liability on revenue account—by the payment of an amount greater than the amount at which that liability has been brought to account as a deduction by an accruals basis taxpayer, or the amount acknowledged to be payable in respect of a borrowing on revenue account. The deduction of a loss in these circumstances is the correlative of the inclusion in income of a specific profit on the discharge of a liability on revenue account.

6.309 The determination of the amount of the specific profit or loss on the realisation of a revenue asset or on the discharge of a liability on revenue account is considered again in Chapter 12 below. Some aspects of the determination of a specific profit or loss in relation to an asset which is a receivable, and in relation to liabilities, require consideration here: there are difficult questions of analysis.

Losses in relation to receivables

6.310 A receivable that may give rise to a profit or loss that is income or deductible will be:

(i) an amount that the taxpayer is entitled to receive, whether in respect of the supply by him of property which is trading stock, in respect of the supply of services, or in other circumstances, if the whole of the amount that the taxpayer is entitled to receive is an amount that must be brought to account as assessable income because the taxpayer is on an accruals basis in relation to the item. (Accruals basis as distinct from cash basis is explained in [11.24]ff. below); and
(ii) an amount that the taxpayer is entitled to receive by way of repayment of a
lending, where the lending is on revenue account.

There may be a third category: an amount that the taxpayer is entitled to receive as proceeds of the realisation of property which is not trading stock, or in respect of the surrender of rights, where the proceeds of realisation or surrender must be accounted for on the arising of a right to receive, in determining a profit that is income or a loss that is deductible. The general rule would be that only an actual receipt will be brought to account in fixing the profit or loss. To the extent, however, that a receivable should be brought to account, the receivable is one in relation to which there may be a profit that is income or loss that is deductible. In category (i) there is, strictly, no lending, but there may be said to be a grant of accommodation by the taxpayer and the accommodation will be granted on revenue account. The accommodation given is a revenue asset. Accruals accounting will not be appropriate unless the receivable arises in the carrying on of a business. In the third category contemplated, the accommodation granted could not be regarded as a revenue asset unless there is a continuing business, a concept explained in [2.437]ff. above. Where there is no continuing business, the receivable has, however, a similar character: any profit or, loss in relation to the receivable that is income or deductible, will be a profit or loss from the carrying out of the isolated venture from which the receivable arose—an isolated business venture, a venture within one of the limbs of s. 25A(1) or, presumably, a transaction within s. 26AAA. These observations in relation to the first and the possible third category assume that there are no special terms in relation to the amount receivable which would displace the presumption that any accommodation granted is on revenue account, or is granted in carrying out the isolated venture. There will, however, be circumstances in which the character of the accommodation granted must be determined on principles which will determine the character of a lending in category (ii) as a grant of accommodation on revenue account. Thus there may be a long term allowed in which the amount receivable might be paid to the taxpayer by the debtor, and the function of the grant of accommodation is the provision of finance for the debtor which is an investment in the debtor: the debtor may be a company that is a subsidiary of the taxpayer. Where these circumstances exist, the grant of accommodation may be seen as being a grant on capital account, or a grant unrelated to the carrying out of the isolated venture, and the receivable will not on realisation give rise to a profit that is income or a loss that is deductible.

6.311 The description of category (i) is confined to a taxpayer who is on an accruals basis in relation to the item. Where the taxpayer is on a cash basis
in relation to the item, the arising of the receivable is simply not an event that can have tax consequences. The accommodation granted is simply ignored. There will however be tax consequences on the actual or constructive receipt of the receivable, which will be substantially equivalent to the consequences for a taxpayer on an accruals basis which flow from the two events, being the arising of the receivable and the realisation of the receivable. Where the taxpayer is on a cash basis in relation to an item, there will be a derivation on actual or constructive receipt as explained in [11.122]ff. below. Where the constructive receipt takes the form of an application by the taxpayer of his entitlement to receive in making a loan to his debtor, there is room to regard the loan by the taxpayer as a lending on revenue account, though the fact that the taxpayer is on a cash basis in relation to the receivable may suggest that his lending is not on revenue account—that there is no business activity to which the lending is incidental so as to give it the character of a revenue asset. And the possibility that he is engaged in a business of moneylending seems unlikely.

6.312 A general principle of tax accounting would require that a taxpayer must be taken to have incurred as the cost of a receivable the amount at which the receivable is brought to account as assessable income, or is brought to account in determining a profit that is income or a loss that is deductible. That principle will supply the cost in determining the amount of the profit or loss that may arise on the realisation of a receivable within category (i) or the possible third category. The cost of a receivable in category (ii) is obviously the amount of the money lent.

6.313 A profit on the realisation of a receivable may arise because the amount of the receivable is expressed in a foreign currency, and the amount received in Australian currency on realisation is greater than the value in Australian currency at which the receivable was brought to account. There is a gain, identified as an “exchange gain”, which is income, being the profit on the realisation of a revenue asset. A loss may arise on realisation because the amount received in Australian currency is less than the value in Australian currency at which the receivable was brought to account. There is then an exchange loss. Where the receivable is money lent, a profit on the realisation of the receivable may arise because the taxpayer receives a premium on the repayment of the loan, either expressed to be such, or a premium in effect because the taxpayer has lent less than the borrower acknowledged he was liable to pay: the borrower may have negotiated at a discount a promissory note in which he gave his undertaking to pay (Willingale v. International Commercial Bank Ltd [1978] A.C. 834). A loss may arise because the taxpayer fails to obtain an
amount in repayment equal to the amount he had lent.

6.314 Profit or loss may be realised not on the receipt of payment from the debtor but on the disposition by the taxpayer of the receivable and the receipt of an amount greater or less than the amount at which the receivable had been brought to account, or greater or less than the amount the taxpayer had lent.

6.315 These propositions are all expressions of basic principles as to the meaning of income and as to the deductibility of expenses under s. 51 (1). There is however a specific provision in s. 63 relating to bad debts. The section has not been taken to cover the field in any sense so as to exclude the operation of s. 51 (1) in determining the deductibility of a loss in relation to a receivable. Some consideration is given to s. 63 in [10.50]ff. below, and some attempt is made to show the correlation between the operation of that section and of s. 51. Two points might be made here. Section 63 allows a deduction in advance of the moment of incurring of a loss in relation to a receivable that is deductible under s. 51. The moment of incurring under s. 63 is the “writing-off” of the receivable. The receivables which may attract a deduction under s. 63 are confined to two classes. The first class would correspond with category (i) in the description of situations in [6.310] above. The receivable must have been brought to account as assessable income: it is not enough that the receivable is brought to account in determining a specific profit or loss. The second class covers only some part of the situations covered by category (ii) in [6.310] above. It extends only to loans on revenue account that are made by a money-lender in the ordinary course of carrying on a business of lending money. It may, it seems, extend to some receipts that are within neither category (i) nor category (ii) in the description of situations in [6.310] above. Interest on money lent in the ordinary course of a business of lending money is “in respect of” money so lent: National Commercial Banking Corp. of Australia (1983) 83 A.T.C. 4715. In this aspect the decision in National Commercial Banking Corp. of Australia produces an unsatisfactory result. There may be a loss deduction in respect of a receivable which would be accounted for as income only on actual or constructive receipt. There may be another illustration of a receivable to which s. 63 applies, that could not give rise to a profit that is income or a loss that is deductible under s. 51(1). A parent company may supply goods to a subsidiary on terms that amount to an investment by the parent in the subsidiary. The receivable might be the subject of a write-off under s. 63. But on the argument adopted in [6.310] above, it could not give rise to a loss deductible under s. 51(1).

6.316 There may be difficulty in determining when a lending is on revenue
account. The situation covered by s. 63 will clearly be such. A bank probably carries on the business of moneylending. In any event, loans by a bank or by a life insurance company are revenue assets on the authority of the banking and life insurance cases considered in [2.456]ff. above. A company carrying on a business of investing, in the manner of the company in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106 which subscribes for debentures, lends on revenue account. A loan made by a taxpayer under a scheme to provide financial assistance to employees, or made to a supplier of goods, or to an outlet for the taxpayer's production, may be a loan on revenue account.

6.317 Section 63 refers to “bad debts”. Presumably a debt is bad when the debtor is unable to pay the full amount of the debt. A debt in a foreign currency is probably not a bad debt simply because a change in the exchange rate has brought about the consequence that payment in full of the debt will in Australian currency yield an amount less than the amount of Australian currency at which the receivable was brought to account, or the amount in Australian currency of the lending on revenue account. It would follow that write-off under s. 63 is not available in relation to an impending exchange loss. A loss deduction in these circumstances must await the realisation of the receivable, so that there is a deduction under s. 51(1).

6.318 There is a question of what is meant by the realisation of a receivable so that there may be an exchange loss or other loss in relation to a receivable under s. 51(1). There is very little assistance in the authorities. In *A.G.C. (Advances) Ltd* (1975) 132 C.L.R. 175, the loss claimed was in respect of a “write-off”, so described, though s. 63 was admitted to be inapplicable. No argument was addressed to the court on the question whether a loss within s. 51(1) had in fact been incurred and the court did not consider the matter. Since *A.G.C. (Advances)*, s. 63A has been added to the Act. The section is clearly intended to control deductions for bad debts by a company whether under s. 63 or s. 51, but in the conditions of deductibility imposed, s. 63A requires that the debt “be written-off as a bad debt” (s. 63A(2)). The section does not define the words “written-off”, though a meaning for the words in line with the interpretation given to them by judicial decisions on s. 63 would clearly be inappropriate.

6.319 A principle that the Assessment Act is concerned only with realised gains and losses, unless there is an express exception, would be generally accepted. It is suggested that a receivable is realised when it is disposed of, when payment of it is received, when there is a receipt by the creditor which will discharge the debtor, or when the debt becomes irrecoverable—the debtor being bankrupt, or recovery being commercially impossible.
6.320 The cases on exchange losses afford only indirect assistance. No Australian case involves an exchange gain or loss on the realisation of a receivable. The cases are all concerned with gains or losses on discharge of liabilities. The cases are: *Texas Co. (Australasia) Ltd* (1940) 63 C.L.R. 382; *Armco (Australia) Pty Ltd* (1948) 76 C.L.R. 584; *Caltex Ltd* (1960) 106 C.L.R. 205; *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347; *Thiess Toyota Pty Ltd* (1978) 78 A.T.C. 4463; *Commercial & General Acceptance Ltd* (1977) 137 C.L.R. 373; *Cadbury-Fry Pascall (Aust.) Ltd* (1979) 79 A.T.C. 4346; *Lombard Australia Ltd* (1980) 80 A.T.C. 4151; *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510; and *Hunter Douglas Ltd* (1983) 83 A.T.C. 4562. However, the cases, especially *Caltex*, reflect an unwillingness to find that a liability has been discharged, in a sense that will require an exchange gain or loss to be brought to account. The unwillingness there reflected may give some basis for inference that the courts will not, on other fronts, readily conclude that a receivable has been realised so that a gain has been derived or a loss incurred.

6.321 The calculation of a loss on the realisation of a receivable must bring to account any proceeds of the realisation. Where the taxpayer has released the debt owed to him, for example under a scheme of arrangement between a company, its shareholders and creditors, there will be difficulty in identifying the proceeds of realisation. The effect of the release given by the taxpayer as a creditor of the company may be to increase the value of shares held by the taxpayer in the company. It would appear from the judgment of Owen J. in *Point* (1970) 119 C.L.R. 453 that the judge might have been prepared to hold in that case that a loss had been incurred by the taxpayer at the time the release of the debt owed to the taxpayer became effective under the scheme of arrangement. But no ground of objection in terms of s. 51 had been taken. The calculation of such a loss would have required a decision on the relevance of the fact that, as a consequence of the taxpayer's release of the debt, there must have been an increase in the value of the shares the taxpayer held in the company. In *G. E. Crane Sales Pty Ltd* (1971) 126 C.L.R. 177 a deduction under s. 51 in relation to the loss on the assignment of the book debts to the receiver and manager would presumably have been defeated by want of contemporaneity—the business of factoring had ceased. If it were not so defeated—some doubts about the contemporaneity doctrine in this context are raised in *A.G.C. (Advances)*—there would be a question of how the release from its debts which the company obtained in exchange for the assignment is to be regarded. The release might be seen as proceeds of the realisation of the book debts.
**Losses in relation to liabilities**

6.322 A liability that may give rise to a profit that is income or a loss that is deductible will be:

(i) an amount the taxpayer is obliged to pay whether in respect of the supply to him of property which becomes his trading stock or in respect of the supply to him of services used in his business, or in other circumstances, if the amount he is obliged to pay is an allowable deduction because he is on an accruals basis of accounting in relation to the item; and

(ii) an amount that the taxpayer is obliged to pay by way of repayment of a loan, where the loan is a borrowing on revenue account.

There may be a third category: an amount that the taxpayer is obliged to pay in respect of rights which are surrendered, where the amount he is obliged to pay must be accounted for in determining a profit or loss that is income or deductible, and is struck before there has been an actual or constructive payment by the taxpayer of the amount he is obliged to pay. In category (i) there is, strictly, no borrowing, but there may be said to be a receipt of accommodation and the accommodation will be treated as received on revenue account: the liability to pay is a liability on revenue account. Accruals accounting will not be appropriate to the incurring of the liability unless the liability arises in the carrying on of a business. In the third category contemplated the accommodation received will not be regarded as a liability on revenue account unless there is a continuing business. Where there is no continuing business the liability has, however, a similar character: any profit or loss that is income or deductible on the discharge of the liability will be a profit or loss from the carrying out of the isolated venture from which the liability arose—an isolated business venture, a venture within one of the limbs of s. 25A(1), or, presumably, a transaction within s. 26AAA. These observations in relation to the first and the possible third category, assume that there are no special terms in relation to the amount the taxpayer is obliged to pay which would displace the presumption that any accommodation is received on revenue account, or is received in the carrying out of an isolated venture. There will, however, be circumstances in which the character of the accommodation received must be determined on principles which will govern the determination of the character of a borrowing as a receipt of accommodation on revenue account. Thus there may be a long term allowed within which the amount the taxpayer is obliged to pay may be paid by him. The function of the accommodation received may in these circumstances be seen as providing the taxpayer with finance which he
receives on capital account: the taxpayer may be a company that is a subsidiary of the creditor who has provided the finance. In these circumstances the liability will not be one that can give rise to a profit that is income or a loss that is deductible on the discharge of the liability. The notion of a borrowing on revenue account involved in the description of the second category is examined in [6.329] below. The assumption there made is that there can be such a borrowing only where there is a continuing business. The possibility cannot, however, be excluded that a borrowing made in the carrying out of an isolated venture which may give rise to a profit that is income or loss that is deductible, is a borrowing that may generate an income profit or a deductible loss on its discharge. The taxpayer may have borrowed in order to acquire property for the purpose of profit-making by sale.

6.323 The description of category (i) is confined to a taxpayer who is on an accruals basis in relation to the item. Where the taxpayer is on a cash basis in relation to the item the arising of the liability is simply not an event that can have tax consequences. Tax accounting simply ignores the accommodation received. There are however tax consequences on actual or constructive payment of the liability which will be substantially equivalent to the consequences for a taxpayer on an accruals basis which flow from the arising of a liability and the discharge of that liability. Where the taxpayer is on a cash basis in relation to an item, there will be an incurring of a deductible outgoing on actual or constructive payment, as explained in [11.174]ff. below. Where the constructive payment takes the form of a loan by the creditor of the amount of the liability, the loan moneys being applied in payment of the liability, there is room to regard the liability assumed by the taxpayer to repay the loan moneys as a borrowing on revenue account, though the fact that the taxpayer is on a cash basis in regard to the original liability may suggest that the borrowing is not on revenue account—that there is no business activity to which the borrowing may be incidental.

6.324 A general principle of tax accounting would require that the taxpayer must be taken to have received the amount at which his obligation to pay in respect of the supply to him of property or services is brought to account as an allowable deduction, or is brought to account as a cost in determining a profit or loss that is income or deductible on the discharge of the liability. The amount is the proceeds of his liability to be set against the costs of discharge. The amount a taxpayer in fact receives in a borrowing on revenue account is the amount of proceeds that will enter the calculation of the profit that is income or the loss that is deductible on the discharge of the liability he has assumed in the borrowing.
The language of “cost” and “proceeds”, appropriate when the question is one of profit or loss on the realisation of an asset, remains appropriate when the question is one of profit or loss on the discharge of a liability. “Proceeds” precede “cost”. A taxpayer who assumes a liability which is an allowable deduction on the acquisition of trading stock receives proceeds of his liability equivalent to the amount of that liability. If, as a result of a movement of rates of exchange, he pays more than the amount of these proceeds when he discharges the liability, he has a cost which exceeds the proceeds and he incurs a loss. A taxpayer who allows a discount when he receives a promissory note has received proceeds of his note which are less than the cost he will incur when he pays the note. When he pays the note he incurs a loss in the amount by which his cost exceeds the proceeds.

It may help an understanding of the tax accounting involved in a gain or loss on the discharge of a liability, to describe the incurring of the liability as the receipt of accommodation of $X. Where, on the discharge of the liability, there is an outlay of $X + $Y, there is a loss of $Y. Where, on the discharge, there is an outlay of $X - $Y, there is a gain of $Y. A parallel description of the gain or loss on the receipt of a receivable is appropriate. The arising of the receivable involves the granting of accommodation of $X. Where, on the receipt of the receivable, there is a receipt of $X + $Y, there is a profit of $Y. Where there is a receipt of $X - $Y, there is a loss of $Y.

There are problems as to what will constitute the discharge of a liability on revenue account, so that there is a profit or loss comparable with the profit or loss that will arise on the realisation of a receivable on revenue account. There are a number of cases concerned with what constitutes the discharge of a liability for this purpose. All of them concern exchange gains and losses. In Armco (Australia) Pty Ltd (1948) 76 C.L.R. 584 the High Court was equally divided on a question whether the giving of a promissory note in respect of a liability for goods supplied was a discharge of the liability. In Caltex Ltd (1960) 106 C.L.R. 205 the payment to the creditor of the amount of a liability to pay in foreign currency for goods supplied, the payment being made out of the proceeds of a loan made to the debtor in the foreign currency by an associate of the creditor, was held not to be a discharge of the liability to pay for the goods so as to generate a deductible loss. The case does not afford any definitive view of the meaning of a discharge that will generate a profit or loss. The decision was by majority, and a variety of views are expressed in the judgments of the majority. They are more closely examined in [12.192]ff. below.

Though there may be difficulties about what constitutes a discharge,
it is clearly established in the exchange gain cases that a gain may arise on a discharge of a liability on revenue account. The leading case is *International Nickel Australia Ltd* (1977) 137 C.L.R. 347 where the gain arose on the discharge in the ordinary course of business of a liability on revenue account. In that case there are references to a United Kingdom decision in *British Mexican Petroleum Co. Ltd v. Jackson* (1932) 16 T.C. 570 where the taxpayer obtained a release from its debts in a compromise with its creditors and the House of Lords declined to find that the release resulted in a profit that was the taxpayer's income. Mason J. in *International Nickel* distinguished *British Mexican Petroleum* on the ground that the discharge of the liability did not occur in the ordinary course of business. Which may suggest a principle that a gain or loss on the realisation of a receivable in circumstances which are outside the ordinary course of carrying on the taxpayer's business will not be income or deductible. A principle of this kind would explain the need for s. 36 of the Act, which requires that the value of certain property, principally trading stock, which are assets of a business, be brought to account as income where the property has been disposed of otherwise than in the ordinary course of carrying on the business.

6.329 The meaning of “borrowing on revenue account” is examined more closely in [12.206]ff. below. Until the judgment of the Federal Court in *Hunter Douglas Ltd* (1983) 83 A.T.C. 4562, the approach taken by the courts had been in terms of the function of the borrowing. Function, for this purpose, refers not to the actual use of the money, found in some kind of tracing of it into outlays, but the need for funds that prompted the borrowing. Borrowing is on revenue account if its function is specifically to discharge a liability on revenue account: *Thiess Toyota Pty Ltd* (1978) 78 A.T.C. 4463, and *Cadbury-Fry Pascall (Aust.) Ltd* (1979) 79 A.T.C. 4346. A borrowing whose function is to finance the acquisition of trading stock is a borrowing on revenue account. And a borrowing to finance loans made by a taxpayer whose business is to lend is a borrowing on revenue account: *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510. However, the judgment of the Federal Court in *Hunter Douglas* is consistent only with an approach that looks to the nature of the borrowing itself, rather than its function. The nature of the borrowing may be seen as involving a broader characterisation, which may be assisted by an identification of the function of the borrowing but is not determined by it. The characterisation of the borrowing as a liability on revenue account will require a conclusion that the borrowing was made in the carrying on of the business of the taxpayer. The borrowing may be directly in the carrying on of the taxpayer's business operations, as it will be where it is a borrowing by a
bank to lend in the course of its business. It may be a borrowing incidental to the carrying on of the taxpayer's business, for example a short term borrowing associated with the establishment of a letter of credit to finance the acquisition of trading stock. Or it may be a borrowing that reflects system and organisation to minimise the cost of borrowing.

6.330 The more limited the room for a conclusion that a borrowing is on revenue account, the more significant will be the distinction between the deduction for a loss on the discharge of a liability and the deduction for interest. It will be recalled that the deductibility of interest on a borrowing does not depend on a characterisation of the borrowing as a liability on revenue account. It is a matter of whether the money was borrowed for the purpose of an outlay in a process of income derivation, and, perhaps, whether the money can for the time being be traced into such an outlay. The taxpayer who borrows on capital account, though for the purpose of an outlay in a process of income derivation, will be denied a deduction for a loss on discharge of the liability, arising, for example, from the payment of a premium on discharge, or the allowance of a discount on the issue of his undertaking to pay. The taxpayer who borrows in this way will be allowed a deduction of interest on the borrowing, provided the money borrowed continues to be outlaid in the process of income derivation. The distinction between premium paid and discount allowed, on the one hand, and interest on the other, is not obvious as a matter of substance, and the differential treatment in tax law may not commend itself. It would be possible to treat premium discount and interest in the same way, and to apply the same common treatment to an exchange loss incurred by a borrower. The possibility of treating an exchange loss as interest on a borrowing was suggested by Rogers J. in *Hunter Douglas* (1982) 82 A.T.C. 4550 at 4559, though he did not pursue the suggestion in making his decision. The possibility may be thought to be excluded by the decision of the High Court in *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510, where it was assumed that a decision that an exchange loss on repayment of a borrowing is deductible requires a conclusion that the borrowing was on revenue account. And we would be left with a strange mixture of analyses if a loss on the discharge of a liability could be treated as deductible as being in the nature of interest paid to secure the borrowing, though the borrowing was on capital account, and a gain on the discharge of the liability is treated as income only when the borrowing was on revenue account. Perhaps such a strange mixture of analyses is already with us. A premium received on the realisation of a lending may in some circumstances be income, at least in part, as a receipt for allowing the use of money by another, irrespective of whether the lending was on revenue
account: *Lomax v. Peter Dixon* [1943] K.B. 671, discussed in [2.285]ff. above. Yet the premium will in other circumstances be income only if the lending was on revenue account. When the question is whether an amount received that is described as interest may be treated as a premium and not as a receipt for allowing the use of property by another, the description, it seems, precludes a conclusion that the amount is to be treated as a premium. These matters are considered in [2.285]ff. above. They concern the situation of the lender. It may be asked whether the treatment of a payment by a borrower described as interest will be determined by the description. It may be asked whether a payment of so-called “penalty” interest on the early repayment of a borrowing is to be treated as interest, and deductible, provided the money borrowed was used in a process of income derivation, or as a premium that may give rise to a loss realised on discharge of the liability, deductible only where the borrowing was on revenue account. A description of the penalty as interest would appear to be in conflict with substance, if interest as a deductible item is a payment to service the use of property. The payment is in respect of a period when the taxpayer has repaid the borrowing and does not have the use of the money.
Chapter 7: Relevant Expenses that are Capital: “Losses or Outgoings of a Capital Nature”

7.1 In Chapter 5, above, attention was given to the framework of s. 51 (1). The view there taken ([5.7]–[5.13] above) is that the exceptions in the concluding part of s. 51 (1) are not true exceptions, but are simply statements of what must be distinguished from items which qualify for deduction under the earlier part of the subsection. Among these exceptions are “losses or outgoings . . . of a capital . . . nature”. A capital loss or outgoing is simply an expense which, though relevant to the derivation of income, fails to achieve deductibility because it is not a working expense.

7.2 It follows that characterisation of a relevant expense as a working expense is a denial that it is a capital expense, and a characterisation of an expense as a capital expense is a denial that it is a working expense. Because of the contradistinction drawn in the excepting of capital expenses, a good deal of decision making on the deductibility of expenses has focused on the question whether the expense is a capital expense, and it is helpful to review the characterisation in these terms of a number of classes of expense.

7.3 In some instances, the focus on the question whether there is a capital expense has tended to cause an oversight of another question which ought to have been given attention—whether there is an expense at all. The view taken in this Volume is that, save where the Assessment Act expressly so provides, the cost of a non-wasting asset is not a deductible expense. It may be a cost which will enter the calculation of a loss which is deductible on the realisation of the asset. It will be such if the asset is a revenue asset. But the incurring of the cost is neither an outgoing nor presently a loss. The cost is best described as an outlay. In these circumstances a characterisation of the cost as capital is an anticipation of a characterisation that will need to be made on the realisation of the asset, when the issue will not be whether there is a deductible outgoing but whether there is a deductible loss. The characterisation of the outlay as capital is a conclusion that the asset acquired is part of the structure of the process by which income is derived, and that a loss on the realisation of that asset will be non-working, and may be described as a capital loss.

7.4 The losses and outgoings considered in Chapter 6 above under the title “Relevant expenses that are working” have for the most part raised issues of relevance rather than issues of working character. Generally, working character has been evident. On occasions, however, the prospect that a loss or outgoing that is relevant might be denied working character because it is
capital was raised. Thus it was noted that a loss arising from the deprivation of an asset may be capital where the asset is a part of the structure of the process by which income is derived. And an outgoing by payment of interest in advance may be capital, if it is seen as the cost of a lasting advantage.

7.5 The losses and outgoings considered in the present chapter are evidently relevant, and the question is whether they have a working character, or, put negatively, whether they should be denied a working character because they are capital. The meaning of capital, so far expressed in the words “related to the structure of the process of income derivation”, has been the subject of a wealth of judicial pronouncements. Classical among these are pronouncements by Dixon J. in *Sun Newspapers Ltd* (1938) 61 C.L.R. 337 in Australia, and by Viscount Cave L.C. in *British Insulated & Helsby Cables Ltd* [1926] A.C. 205 in the United Kingdom.

7.6 Dixon J. in *Sun Newspapers Ltd* said:

> “The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlay, the difference between the outlay and returns representing profit or loss. The business structure or entity or organisation may assume any of an almost infinite variety of shapes and it may be difficult to comprehend under one description all the forms in which it may be manifested. In a trade or pursuit where little or no plant is required, it may be represented by no more than the intangible elements constituting what is commonly called goodwill, that is, widespread or general reputation, habitual patronage by clients or customers and an organised method of serving their needs. At the other extreme it may consist in a great aggregate of buildings, machinery and plant all assembled and systematised as the material means by which an organised body of men produce and distribute commodities or perform services. But in spite of the entirely different forms, material and immaterial, in which it may be expressed, such sources of income contain or consist in what has been called a ‘profit-yielding subject’, the phrase of Lord Blackburn in *United Collieries Ltd v. I.R.C.* (1930) S.C. 215 at 220” (at 359–360).

...
into existence or procure some asset or advantage of a lasting character which will endure for the benefit of the organisation or system or ‘profit-earning subject’. It will thus be distinguished from the expenditure which should be recouped by circulating capital or by working capital” (at 361).

“... 

“There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment” (at 363).

7.7 No pronouncement will, however, be definitive. The judgment of Dixon J. is referred to in all the judgments in the High Court in Cliffs International Inc. (1979) 142 C.L.R. 140. Yet the conclusion that there were deductible outgoings was reached only by a majority. The first of the matters which Dixon J. thought should be considered will no doubt be determinative if there is a single outlay that is fairly to be regarded as a cost of the advantage, and the advantage is part of the structure of the process of income derivation. But Cliffs International indicates that the characterisation of an outlay as a cost of an advantage may take the enquiry beyond the terms of any contract which concerns that advantage. The second matter—the manner in which the advantage is to be used, relied on or enjoyed—must bear on the question of the character of the advantage. The second matter is thus no more than an indication of what may determine the character of the advantage referred to in the first matter. The third matter focuses on the identification of the advantage. The advantage may be the right to present and future use and enjoyment of property or it may be only the current enjoyment of property. An illustration may be found in the distinction between a lease giving rights to present and future enjoyment, secured by the payment of a premium, and the current enjoyment secured by the payment of rent under the lease. And the matters to which Dixon J. drew attention are only some of the matters that are relevant to a conclusion that an expense is a capital expense. It will be seen that an expense may be denied deduction on the ground that it is a capital expense though no asset or advantage is secured by the expense.

7.8 The pronouncement taken from the judgment of Viscount Cave L.C. in British Insulated & Helsby Cables that has become classical is:

“But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading
to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital”: [1926] A.C. 205 at 213–214.

The pronouncement by Viscount Cave L.C. puts emphasis on the “bringing into existence of an asset or advantage for the enduring benefit of the trade”, and there is a like emphasis on this factor in the pronouncements of Dixon J. It will appear from the examination of the judgments in the High Court decision in John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 later in this chapter, and more especially the judgment of Dixon C.J. in that case, that, at least in Australian authority, bringing into existence an enduring advantage is not a necessary condition of the characterisation of an outgoing as capital. The problems of characterisation of losses and outgoings as working or as capital are considered under headings which distinguish situations where an asset is acquired, from situations where no asset is acquired.

**Characterisation of the Costs of Acquiring Assets**

**Structural assets and revenue assets; non-wasting assets and wasting assets**

7.9 The distinction between working expenses and capital expenses justifies the assertion of a general principle that the cost of acquiring a capital, or perhaps the better term, a structural asset—an asset that is part of the structure of the process of income derivation—is not deductible, nor is a loss on the realisation of such an asset deductible. It does not of course follow that the cost of acquiring a revenue asset—an asset that is not part of the structure of the process of income derivation—is deductible. An explanation has already been offered ([5.24] above) of s. 51 (2) that it specifically displaces a principle that the cost of a non-wasting revenue asset is not deductible, and allows a deduction as part of the special regime, in ss 28ff., applied by the Assessment Act to trading stock. In other circumstances the cost of a non-wasting revenue asset is not deductible, though that cost may enter the calculation of a loss that is deductible on the realisation of the asset. The cost is not an outgoing: it is no more than an outlay. The concept of a non-wasting revenue asset covers assets in which a business deals, or which is otherwise turned over in the carrying on of the business such as the investments of a life insurance company or banking company or the investments of the taxpayer in London Australia Investment Co. Ltd (1997) 138 C.L.R. 106. And it covers a receivable which is a revenue asset and which may give rise to a loss or gain on realisation—an exchange loss or gain, for example, or a loss arising because the receivable becomes a bad debt and is realised for less than its cost. The asset may waste, in some sense of the word, but the wasting is not the consumption of the cost of the asset in the process of income derivation. A motor vehicle is a non-wasting revenue asset of a business that deals in cars. A motor vehicle is a wasting, though very likely a
capital, asset of a business that uses motor vehicles in the transporting of its products. The conclusion in both *Nchanga Consolidated Copper Mines Ltd* [1964] A.C. 948 and *B.P. Australia Ltd* (1965) 112 C.L.R. 386 may be explained as a conclusion that the asset acquired—a relatively short term restriction on another's activity which would have involved competition with the taxpayer—was a wasting revenue asset. Export entitlements acquired by an exporter and import licences acquired by an importer are very likely wasting revenue assets.

7.10 Where a wasting asset is a structural asset, the cost of it will not be deductible and a loss on realisation of the asset will not be deductible under s. 51 (1). The cost may, however, be deductible under express provisions allowing deductions for depreciation or amortisation of the costs of wasting capital assets, for example those relating to depreciation of plant or articles used in a process of income derivation (ss 54ff.), amortisation of items of commercial or industrial property used in a process of income derivation (Div. 10B of Pt III), and provisions which have a like operation specifically in relation to the mineral and timber industries (Divs 10, 10AA and 10A of Pt III). Where no express provisions allow deductions, the cost of a wasting structural asset, for example the asset acquired by the taxpayer in *Strick v. Regent Oil Ltd* [1966] A.C. 295 or by the taxpayer in *Ballarat & Western Victoria T.V. Ltd* (1978) 78 A.T.C. 4630, will not be deductible at any time. A payment of interest in advance, such that a lasting advantage in the use of money thereafter at no or low interest is achieved, may be seen as the cost of a wasting capital asset so that the payment in advance will not be deductible at any time. The matter is considered in [6.86]–[6.141] above. The costs of acquiring know-how that is a structural asset will not be deductible at any time, though those costs are consumed in the taxpayer's manufacturing operations. The costs of acquiring a restrictive covenant given by an employee are not deductible, though the advantage of immunity from competition is a business advantage that wastes over the period of the covenant. The costs of acquiring goodwill are not deductible at any time. In this last instance there may however be an argument that the goodwill does not waste in the carrying on of a business.

7.11 Where the wasting asset is a revenue asset the cost of it, it is generally assumed, is deductible at the time the cost is outlaid. The cost is treated as an immediate outgoing. In dealing with the deductibility of interest paid in advance in [6.86]ff. above, it was suggested that where the asset acquired—the use of money at no or low interest in the future—is a revenue asset, the interest outgoing is incurred not at the time of payment but over the period of the borrowing as the interest cost is consumed. Such an approach was taken in *Arthur Murray* (1965) 114 C.L.R. 314 in regard
to the derivation of income. It was also suggested that if the interest cost is not treated as incurred in this way, it should not qualify as a relevant expense. A claim for the deduction of interest on money borrowed may well depend on a showing by the taxpayer that the money borrowed is outlaid and will continue to be outlaid during the period to which the interest relates in a process of income derivation. A taxpayer cannot satisfy this onus in relation to interest paid in respect of the future use of money and the interest so paid will not be deductible.

7.12 Where the advantage gained in acquiring a wasting revenue asset appears to have no function save in a process of income derivation—the advantage in *B.P. Australia* or in *Nchanga*—the taxpayer claiming an immediate deduction can satisfy the onus of showing that his cost is relevant. And if he realises the asset there is the prospect that he will derive income in the form of a profit. In theory that profit is the amount by which the proceeds of realisation exceed the cost of the asset, but s. 82 will preclude the subtraction of the cost already allowed as a deduction. The Commissioner is, however, at risk that the asset may be realised in circumstances which do not involve any receipt by the taxpayer of the value of the asset. He may dispose of the asset to an associate for less than its value, or make a gift of the asset to another, as the taxpayer did in *Mason v. Hammond Innes* [1967] 2 W.L.R. 479, or the cost may be consumed in circumstances which show no continuing relevance to a process of income derivation. Unless some general principle of the kind adopted in the United Kingdom in *Sharkey v. Wernher* [1956] A.C. 58, which imports a deemed realisation at market value, is held applicable, the whole of a cost will have been allowed, notwithstanding that, in the events which have occurred, that cost has not in the whole of its amount been incurred in a process of income derivation.

7.13 Insisting that the cost of a wasting revenue asset is incurred only as the cost is consumed will mitigate this unfairness to the Commissioner. There will however be problems in determining what costs are ordinary deductible outgoings and deductible immediately, and what costs are to be regarded as costs of revenue assets and deducted only as they are consumed. The problems have some kinship with those which arise under the trading stock provisions in drawing a distinction between “overheads” or “on-costs”, which must be so treated and, in effect, deferred by the operation of the trading stock provisions until the items are realised, and other overheads which will formally and in effect be deductible immediately.

7.14 The problem of distinguishing ordinary outgoings in carrying on a business from the costs of non-wasting revenue assets which the business
produces and which are turned over in carrying on the business, is highlighted in the United Kingdom decision in *Mackenzie v. Arnold* (1952) 33 T.C. 363. An author may make a number of outlays, for example for travel in researching material for a novel. There will be problems going to contemporaneity if it is not yet evident that he has entered on a business of authorship. However, even if it is accepted that a business has commenced there are problems of distinguishing costs which are ordinary outgoings in carrying on the business, and deductible if they are relevant, and costs which are not deductible but may enter the determination of a loss or a profit on the realisation of the copyright in the novel that is written following the research. Other problems are posed if the author is a non-resident at the time he engages on research. The research expenses, if the author should submit a return and claim deduction for them, will presumably be denied deduction as not relevant to the derivation of assessable income. Even if the costs are seen as present outgoings, the author will none the less be unable to establish the relevance of those outgoings to the derivation of assessable income. If he remains a non-resident the sale of the copyright can generate assessable income only if the gain on realisation has an Australian source.

7.15 If the costs are treated as costs of acquiring the copyright in the novel that he writes, they will enter the calculation of a loss or profit on realisation, which will be deductible or be assessable income if the author is at the time of realisation an Australian resident. The loss will be deductible and the profit assessable income, unless the income that would have resulted or does result is exempt under s. 23 (q) as foreign source income subject to tax in the country of source. Treating the costs of research as costs of the copyright may be thought to produce the more logical and the fairer outcome.

7.16 The assumption in the observations just made is that copyrights are not trading stock of an author. If a copyright is to be treated as trading stock and the research costs are to be treated as costs of the copyright, the operation of the trading stock provisions (ss 28ff.) will be to allow outgoing deductions at the time of incurring those costs. The outgoings will however be deferred until the year in which the copyright is realised. The operation of the trading stock provisions becomes distorted if the taxpayer is not resident at the time of incurring the costs and becomes resident at the time of realisation. There is a prospect of denial of the outgoing deductions for costs of the copyright, notwithstanding that the proceeds of realisation are assessable income. The prospect is a consequence of the departure from basic principle involved in the statutory regime.
Costs of trading stock

7.17 It follows from the analysis in the immediately preceding paragraphs that costs of trading stock are not outgoings deductible under s. 51 (1), if that subsection is considered without the assistance of s. 51 (2). Trading stock are non-wasting revenue assets and their cost is an outlay, not an outgoing, though the cost will enter the calculation of a loss that is deductible on the realisation of the trading stock. Section 51 (2) has displaced this operation of the Act. The subsection is part of a special regime applicable to trading stock as defined in s. 6. That regime is contained in Subdiv. B of Div. 2 of Pt III. It was the subject of some observations in ([5.24]) and is dealt with in more detail in Chapter 14 below. Where assets are turned over in the carrying on of a business but are not trading stock—the investments of a life insurance company or a banking company, or the investments in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106—the cost of an asset is not deductible though it will enter the calculation of loss or profit on realisation.

7.18 Difficulties in distinguishing costs which are to be treated as costs of trading stock and costs which are ordinary deductible outgoings may be suggested by the discussion of the difficulties of identifying the costs of a copyright which is produced by the work of an author, in [7.14]–[7.16] above. Other difficulties arise in distinguishing costs which relate to the acquiring of a source of supply of trading stock and costs of acquiring trading stock.

7.19 Costs which relate to the acquisition of a source of supply of trading stock, for example mining rights, or land with standing timber, will ordinarily be non-wasting and not deductible. Where the taxpayer deals in mining rights, in timber bearing land or in rights to take timber from land, the costs of acquisition will be deductible as costs of rights or land which are themselves trading stock. Where, however, he proposes to use the rights or land as a source of supply of trading stock in the form of minerals or timber, the costs of the rights and land are not deductible. The rights and land are structural assets and the taxpayer must in general rely for any tax relief in respect of the costs of them on provisions of the Assessment Act in Divs 10, 10AAA, 10AA, 10A which relate to the mining and timber industries.

7.20 What is said of land bearing timber is applicable to land which includes soil, sand or gravel, which the taxpayer acquiring the land proposes to take from the land and sell, or to rights to take soil, sand or gravel which the taxpayer acquiring the rights proposes to exercise in order to acquire the commodity for sale. In these instances, however, there are no
provisions of the Act giving any relief in respect of the costs of acquiring the land or rights.

7.21 In some circumstances it may be held that the taxpayer has not acquired rights or land which will yield trading stock, but has acquired the stock immediately and is therefore entitled to a deduction of his costs of trading stock. The distinction between acquiring “the means of obtaining [the] raw material” of a business and acquiring “[the] raw material itself” (Golden Horse Shoe (New) Ltd v. Thurgood [1934] 1 K.B. 548 at 565) is not definitively drawn in the cases. Golden Horse Shoe involved dumps of gold mine tailings and the purchase of the tailings was held to be the acquisition of trading stock. It may be important that the dumps were not a natural part of the soil. In Kauri Timber Co. Ltd v. C. of T. (N.Z.) [1913] A.C. 771, one of the transactions with which the case was concerned was a purchase of timber standing on land with a right to remove the timber. The Privy Council treated the transaction as the purchase of a source of trading stock. In Stow Bardolph Gravel Co. Ltd v. Poole [1954] 1 W.L.R. 1503 the purchase of deposits of sand and gravel was treated in the same way. The conclusion reached by Buckley J. in Hopwood v. C. N. Spencer Ltd (1964) 42 T.C. 169 is not easily reconciled with Kauri Timbers and Stow Bardolph Gravel. A purchase of land carrying timber entered into by the shareholders of a company was construed as a purchase by the shareholders, for themselves, of the land apart from the timber, and a purchase for the company of the timber on the land. Buckley J. concluded that the company had purchased the timber as trading stock. The matter’ is the subject of further consideration in [14.39] ff. below and in [6.179]ff. above.

7.22 The denial of a deduction for the cost of the means of obtaining trading stock leaves open the possibility of a deduction of the value of an item at the moment the taxpayer acts to take the item into his business as trading stock. In the situations envisaged in previous paragraphs, that moment is the time immediately before trees are severed, or soil, sand or gravel is quarried from the soil. The deduction is of the value of the item before any value is added by the severance or quarrying. Where the land and its timber, soil, sand or gravel has become committed to a business of exploiting the resource, the more appropriate time at which to value in determining the cost on taking would be the time the commitment was made. At least in the case of timber, which is a renewing resource, it is appropriate to bring in as income any increase in value of the timber between the time of commitment and the time of taking. Allowing as cost the value of the timber at the time of commitment will achieve this.

7.23 The United Kingdom cases and the Australian decision in White
(1968) 120 C.L.R. 191 are not necessarily opposed to allowing a cost in this way at the time of taking. The possibility of allowing such a cost is raised in at least one of the United Kingdom cases. It was not raised in White. The matter is the subject of consideration in [6.195]ff. above.

7.24 The principle is accepted that a taxpayer who takes an item, which until now he has held privately or as a capital asset, and makes it a revenue asset of his business, is entitled to a deduction if the item forthwith becomes trading stock, or to a subtraction in computing any loss or profit on realisation if it forthwith becomes a revenue asset but not trading stock. The principle was accepted, most recently, in Curran (1974) 131 C.L.R. 409 by Gibbs J., though, with respect, it was in that case misapplied: the principle can have no application to an item which is a receipt in carrying on a business. The bonus shares and the amount applied in paying them up were receipts in carrying on the business of the share trader taxpayer. To allow a deduction of the value of the item, or a subtraction in computing the loss or profit on its realisation, is to confound the income tax in its most basic operations. If the item is properly to be regarded as an item of exempt income, there is room for a principle which will require the protection of the exemption by allowing a cost, so that the item is exempted not only at the time of its derivation but also at the time of its realisation. Some such principle may explain the judgment of Barwick C.J. in Curran, though, with respect, it, too, was misapplied. The High Court had settled in Gibb (1966) 118 C.L.R. 628 that a bonus issue from a capital profit is not exempt income—it is simply not income. And there is need of another principle—that where an item is received and its value is income, a deduction must be allowed of that value as a cost of that item if it is trading stock, or a subtraction of the value must be allowed in computing the loss or profit on its realisation if it is a revenue asset but not trading stock. The deduction or subtraction must be allowed to prevent double tax. Treating the value of the item as income may be regarded as bringing in the proceeds of a notional realisation. The asset must then be deemed to have been re-acquired at a cost equal to the amount of those proceeds. In Curran, on the previous authority of Gibb, the bonus issue was neither an item of exempt income nor of assessable income. An allowance of a deduction or subtraction was inappropriate. It would have been appropriate had the item been a bonus issue from a revenue profit, in which case there would have been an assessable dividend, and to the extent of the amount of the income assessed a deduction should be allowed as the cost of trading stock. A contrary view expressed in the judgment of Stephen J., who dissented in Curran, is, with respect, unacceptable.

7.25 Where the item has been acquired otherwise than in carrying on the
business—where it is held privately or as a structural asset of the business prior to its being taken in as trading stock or other revenue asset—the value of the item is deductible or subtractable so as to ensure that the taxpayer is not taken to derive as income what is, in effect, his investment in the business.

7.26 The allowance of a deduction or subtraction of the value of the item immediately before it is taken into the business as a revenue asset will pose difficult problems of valuation, but they are problems which the law has to meet in other contexts: like problems must have arisen in computing the profit that was held, in principle, to be an item of income in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355.

7.27 The allowance of a deduction should extend to situations where the taxpayer does not own the item prior to its being acquired as trading stock: a right to take will need to be valued. There is a precedent for valuing a right that is exercised in acquiring a revenue asset, and allowing that value as a cost in computing the profit from the realisation of the asset, in the decision of Kitto J. in *Executor, Trustee & Agency Co. of S.A. Ltd (Bristowe’s case)* (1962) 36 A.L.J.R. 271.

7.28 In some circumstances the allowance of a deduction or subtraction of the value of the item may, by inference, be excluded by specific provisions of the Act. Thus, s. 124J allows a deduction of a part of the cost to a taxpayer of acquiring land carrying standing timber, where the timber is felled by the taxpayer and taken into a business as a revenue asset of that business or where the taxpayer derives royalty income as a result of giving rights to another to fell the timber. Where land is acquired carrying standing timber the operation of the section depends on a part of the cost of the land being shown to be “attributable” to that timber. The operation of s. 124J is less than satisfactory where the land has been acquired perhaps many years before the operations from which income is derived are embarked upon. It is arguable none the less that the specific provisions of s. 124J exclude the general principle that would allow deductions or subtractions as the land is taken into the operations from which income is derived.

The identification of “cost”

7.29 Some indication of the problems in identifying a cost as a cost of a non-wasting revenue asset may emerge from the discussion of the research costs of an author in [7.14]–[7.16] above. Where the asset is trading stock, there are a number of judicial decisions, considered in [14.30]ff. below, principally concerned with the question whether costs which go beyond the
more immediate costs are to be regarded as costs of trading stock which will be deferred by the operation of s. 28 if the item is still on hand at year end. The question in the language of accounting is whether deferral is required of “direct” costs only, or must be applied also to “on-costs”, or, again, whether “direct” costing or “absorption” costing is to be applied.

7.30 The relevant item of expense where the trading stock provisions apply is a deemed outgoing deductible under s. 51 (2), but subject to deferral by the operation of s. 28. Where the item is a non-wasting revenue asset, the relevant item of expense is the loss that may arise on the realisation of the asset. The cost of the asset is not an outgoing. It is an outlay. Whether the item of expense is a deemed outgoing under s. 51 (2), or a loss arising because the proceeds of realisation are less than the outlay in acquiring the asset, the requirements of contemporaneity and relevance applicable to an ordinary outgoing will apply.

The costs of acquiring structural assets

7.31 The word “asset” is not intended to have a meaning that will import the notions of proprietary rights which belong to the law of property. A more appropriate term—indeed the term used by Dixon J. in the classical formulation of principle in *Sun Newspapers Ltd* (1938) 61 C.L.R. 337 ([7.6] above)—is “advantage”. The use of the word asset in accepted formulations of principle carries the risk that an argument of the kind made by counsel in *Ilbery* (1981) 81 A.T.C. 4234; 81 A.T.C. 4661 referred to in [6.118] above may prevail. Counsel argued that the prepayment of interest was not a capital outgoing for it did not involve an acquisition of an asset: “If you make a list of [the taxpayer's] assets on the day before and after the transaction, there would be no change.” The submission was made in [6.117] above that the advantage of being entitled to retain borrowed money at no interest or at low interest rate obtained by a payment of interest in advance may be a structural asset. The advantage of having a superannuation fund available to its employees which results from a substantial initial contribution establishing the fund, is a structural asset of the company making the payment. This was the conclusion in *British Insulated & Helsby Cables Ltd* [1926] A.C. 205 from which the classical formulation of principle by Viscount Cave L.C., quoted in [7.8] above is taken.

7.32 The range of assets that may be structural is not limited by any legal or commercial notions of property. Some indication of what may be included may appear from the discussion of Propositions 14 and 15 in Chapter 2 above. *Van den Berghs Ltd v. Clark* [1935] A.C. 431 at 442 is
authority that a contract which relates to “the whole structure of the [taxpayer's] profit-making apparatus” is a structural asset. Rights under an insurance contract may be structural. *Ransburg Australia Pty Ltd* (1980) 80 A.T.C. 4114, discussed in [6.235]–[6.241] affords an illustration. In *ECC Quarries Ltd v. Watkis* [1975] 3 All E.R. 843 rights inherent in planning permission to extract sand and gravel from land were held to be structural, and the costs of an unsuccessful application for such permission denied deduction as capital.

### 7.33 Immunity from competition may be a structural asset. The cost to the company of a restrictive covenant taken from an employee was denied deduction in *Associated Portland Cement Manufacturers Ltd v. Kerr* [1946] 1 All E.R. 68. The immunity gained by the payment, at least if it is judged by the ambit of the restriction placed on the employee, was substantial. The observations of Lord Greene in the Court of Appeal, however, stress the commercial significance to the taxpayer of the immunity. *B.P. Australia Ltd* (1965) 112 C.L.R. 386, in concluding that the costs of the agreements between garage proprietors and the taxpayer were not capital outgoings, had regard to the significance of each individual tie in the total operations of the taxpayer.

### 7.34 The House of Lords in *Strick v. Regent Oil Ltd* [1966] A.C. 295, in concluding that the costs of similar tie agreements were capital outgoings, also had regard to the significance of each individual tie. But the conclusion was assisted by the circumstance that the payments were in terms premiums paid by the taxpayer for leases to the taxpayer of the garage premises owned by the garage proprietors. There is an assumption in the judgments of the House of Lords of a rule of extended form which may insist that, save where a taxpayer deals in leases, a lease is always a structural asset and a premium paid for the lease is a capital outgoing. In this aspect the case may express an approach to the determination of what an outgoing is for—what is the purpose or function of the outgoing—in terms of extended form and blinkers. It is an approach that is at odds with the approach taken in *Dickenson* (1958) 98 C.L.R. 460 in reaching a conclusion as to what a receipt was for. A receipt expressed to be for a restrictive covenant was ultimately judged to have that character, but that judgment is expressed in the commercial language of “giving up a sphere of action”, and it was made only after a close consideration of all the circumstances.

### 7.35 It is true that an extended form and blinkers approach was taken by the Privy Council in the New Zealand appeal in *Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2)* (1976) 76 A.T.C. 6001, encouraged by the Australian High Court decision in *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430, and that
extended form and blinkers, though qualified, was adopted by the High Court in *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645. Some comment on this development has already been made, and there are further comments later in this chapter. But those cases raised a question of relevance of an outgoing, rather than the issue of working as distinct from capital character of a relevant outgoing. In the latter field the statement of Dixon J. in *Hallstroms Pty Ltd* (1946) 72 C.L.R. 634 at 648 remains unquestioned: “What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.”

7.36 A taxpayer may enter on a course of action that involves the obtaining of an immunity from competition that might have come from a number of persons. In *B.P. Australia* the taxpayer followed the practice of securing ties with garage proprietors to the end that all its outlets would sell the taxpayer's products exclusively. The judgments in the case consider each tie severally in the context of the taxpayer's total business operations. An approach that treated all the ties secured by the taxpayer as one advantage to be judged as structural or revenue, may require a conclusion that each tie is structural as part of a total structure. Treating each tie severally is an encouragement to a number of short term and limited area ties, which may indeed be secured by contracts with the same person.

7.37 In *Sun Newspapers Ltd* (1938) 61 C.L.R. 337 the payment was for an interest in a newspaper published in competition with the taxpayer's paper, the taxpayer proposing to shut down the rival paper, and for a covenant by the person from whom the interest was acquired not, for 3 years, to publish another newspaper within 300 miles of Sydney. The payment was denied deduction as a capital outgoing. The payment was seen as achieving an increase in the taxpayer's goodwill. *Sun Newspapers* contrasts with the United Kingdom case of *Nchanga Consolidated Copper Mines Ltd* [1964] A.C. 948 where deduction was allowed of a payment by a taxpayer copper producer, under an agreement by which the producer receiving the payment would shut down its operations for a year. The payment was made in conjunction with payments by other producers. The object of the payments was to achieve a temporary restriction in output in a period of over-supply. The distinction between the cases must rest on the greater significance of the immunity from competition secured in *Sun Newspapers* compared with that secured in *Nchanga*.

7.38 If a payment to secure immunity from competition may be seen as a capital outgoing, a payment to secure entry to a market may be capital. If
the company that had received the payment in *Sun Newspapers* had itself subsequently made a payment to secure a release from its covenant, that payment would presumably have been a capital outgoing.

7.39 A conclusion that an asset is structural and the cost of it not deductible must always depend on a judgment of the significance of the asset to the process of income derivation. In making that judgment a rule of accounting that would capitalise an expense of an asset, and amortise that expense if the asset is a wasting asset, and the action of the taxpayer in applying that rule in his own accounts, will have a bearing but will not be definitive. The recognition of a bearing appears in the judgments in *B.P. Australia Ltd* (1965) 112 C.L.R. 386 at 403 and in *Strick v. Regent Oil Ltd* [1966] A.C. 295 by Lord Morris (at 334) and Lord Reid (at 316). The extent of the bearing of rules of accounting and the fact that they have been applied is a pervasive question: it is not limited to the characterisation of outgoings. It was raised in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314 on the question of when an item of income is derived. It is raised on questions of the general basis of tax accounting—cash or accruals—which may apply to a taxpayer. Courts in both Australia and the United Kingdom are agreed that accounting rules and the application of them are significant but not decisive. *Odeon Associated Theatres v. Jones* [1973] Ch. 288 and *Heather v. P.E. Consulting Group Ltd* [1973] Ch. 189 suggest they have a greater significance in the United Kingdom than in Australia. Both *Arthur Murray* and *Henderson* (1970) 119 C.L.R. 612 in Australia may be thought to minimise their significance.

7.40 The relevance of accounting rules and their application in relation to the characterisation of an asset as structural or revenue, may be thought to be affected by the differing consequences of the characterisation. An accountant will amortise the cost of a wasting asset over the life of the asset. Amortisation, for tax purposes, of the cost of a wasting capital asset will be allowable only where express terms of the Assessment Act provide for this. Which may suggest that the capitalisation of the cost of an asset should be the less readily accepted for tax accounting than for financial accounting.

7.41 In commenting on the suggestion of a form and blinkers approach in the judgments of the House of Lords in *Strick v. Regent Oil* in [7.35] above, reference was made to the judgment of Dixon J. in *Hallstroms Pty Ltd* (1946) 72 C.L.R. 634 as unquestioned authority rejecting such an approach in Australia when the issue is whether an outgoing is working or capital. There are United Kingdom cases in which the *Hallstroms* approach in terms of a practical or business point of view is taken. Thus in *Royal Insurance Co. v. Watson* [1897] A.C. 1, a payment was made by the
taxpayer, which had acquired the business of another insurance company, to a former employee of the latter company who had become an employee of the taxpayer. The payment terminated the employee's services. The payment was not however characterised as a payment to terminate his services, but a payment to acquire the business. The agreement under which the taxpayer acquired the business provided for the making of the payment, and the Lord Chancellor thought it appropriate in characterising the payment to look at “the whole circumstances of the transaction” (at 6).

7.42 Looking to all the circumstances will not necessarily require a characterisation at odds with the form of the payment. Thus in Australia in *Morgan* (1961) 106 C.L.R. 517 the fact that a payment expressed to be by way of adjustment of rates was provided for in an agreement by which property was acquired did not dictate a conclusion that the payment was a cost of acquiring the property. *Morgan* was relied on by Walters J. in *Goldsbrough Mort & Co. Ltd* (1976) 76 A.T.C. 4343 in reaching a conclusion, in this instance against the taxpayer, that the receipt of a like adjustment was not proceeds of sale of the property but an adjustment of rates, as it was in form. The circumstance that the amount of the receipt would vary depending on the time of settlement reinforced the inference from the form of the agreement. *Morgan* may be contrasted with *Foxwood (Tolga) Pty Ltd* (1981) 147 C.L.R. 278 where a payment to the purchaser of a business in respect of long service leave obligations undertaken by the purchaser was treated by the court as an abatement of the purchase price of the business. In this instance the characterisation of the payment rejected its form.

7.43 The general principle considered in [2.34]ff. above, that the character of an item must be judged in the circumstances of its derivation by the taxpayer, is matched by a principle that the deductibility of a loss or outgoing must be judged in the circumstances of the incurring of the loss or outgoing by the taxpayer who claims the deduction. There is no principle that a receipt which is income in the hands of the receiver is deductible by the payer. None the less it would be a theoretically proper result if a view of the facts taken in characterising a receipt as income or otherwise in the hands of the payee were also to be taken in characterising the payment as deductible or otherwise by the payer.

7.44 There is, of course, no estoppel that will bind the Commissioner, a board, or a court to take the same view in relation to payee and payer. Where the assessment of the payer is before a court, the court will not know how the payee has been assessed. None the less, it is proper that a receipt seen to be for entering into a restrictive covenant when the question is whether the person receiving derives income, should be seen as a
payment for the restrictive covenant when the question is whether the payer is entitled to a deduction. Where the conclusion is that a receipt expressed to be for a restrictive covenant given by an employee is from a practical or business point of view a further receipt of a reward for services, it should retain that complexion when the deductibility of the payment by the employer is in question as it was in Associated Portland Cement Manufacturers Ltd v. Kerr [1946] 1 All E.R. 68.

7.45 There is no principle that a series of receipts which are income of the receiver are deductible by the payer. But the view of the facts which gives the series of receipts its income quality in the hands of the receiver should, in theory, be adopted when the question is deductibility by the payer. A view of the facts in Cliffs International Inc. (1979) 142 C.L.R. 140 which would make the receipts by Howmet Inc. and Mt Enid Pty Ltd income, as being, in a broad sense, gains from the use of property, should also be taken when the question is the deductibility of the payments. An acceptance of a theory of this kind may explain the observations by Barwick C.J. that the receipts by Howmet and Mt Enid were income. The receipts were not for the right to use, but in respect of the actual use of the mining rights vested in Cliffs by the events which began with the sale by Howmet and Mt Enid of their shares in the company—Basic—which had those mining rights. The payments by Cliffs International were tolls payable on the occasions of use of the mining rights and, as such, were working expenses. They were in effect costs of use. From a practical or business point of view it was really irrelevant to the characterisation where the property in mining rights rested. It will be recalled that the third matter of those considered relevant by Dixon J. in Sun Newspapers Ltd (1938) 61 C.L.R. 337 to the characterisation of an outgoing as revenue or capital was the means adopted to obtain the advantage sought. The third matter might have been expressed in terms that would have asserted that the means of payment bears on the identification of the advantage. The means of payment in Cliffs International indicated that the advantage obtained was the use of the mining rights. A payment for use is not a payment to obtain structure. Cliffs International does not stand for a principle that the manner of payment for a structural asset can convert what would otherwise be capital expenses into working expenses.

7.46 Cliffs International (1979) 142 C.L.R. 140 should be seen as rejecting an extended form and blinkers approach to the interpretation and application of s. 51, in favour of an approach which looks to the practical or business significance of the expense. It is true that Barwick C.J. sought to reconcile his conclusion with a form and blinkers approach. A judicially adopted rule that would say that a payment for a structural asset is a capital
outlay and is not deductible creates a hazard for a taxpayer if a form and blinkers approach is taken to the application of the rule. A taxpayer who enters a transaction which gives rise to legal relations which require a payment by the taxpayer in consideration of the acquisition of an asset, has stumbled into a transaction which will deny him deductions. In the operation of the rule, the form approach identifies consideration for the payment with what the payment is for, and insists that no other aspect of the circumstances is relevant to a conclusion on that issue. Barwick C.J. sought to fit his conclusion that the payments in *Cliffs International* were not for the shares, despite the description of the payments as “deferred payments” of the “price” of the shares, by an assertion that the words were a wrong description having regard to all the terms of the contract. The description, he said was “quite obviously inapt” (at 148). “The recurrent payments were not made for the shares though it might properly be said that they were payable as a consequence of the purchase of the shares” (at 149). This might be thought to turn the form and blinkers approach in on itself and demonstrate its barrenness in the interpretation and operation of s. 51(1). The issue in *Cliffs International* was whether the payments were working expenses. A conclusion that they were is sufficiently explained by saying that a payment which is a toll payable for the use of a business asset is a working expense and it is irrelevant where the legal title to the asset may rest. A statement of that kind explaining the conclusion should not, however, be taken to be a rule. The statement is intended to express a practical or business judgment of the circumstances.

7.47 In *Cliffs International* the payments were required over the whole life of the mine. A view of the payments as tolls payable for the use, rather than payments for the asset used, is more easily taken in these circumstances than it is when the payments are to extend only for part of the life of the asset, as in *Colonial Mutual Life Assurance Society Ltd* (1953) 89 C.L.R. 428 which was referred to and distinguished in *Cliffs International*. In *I.R.C. v. Land Securities Investment Trust Ltd* [1969] 1 W.L.R. 604 the payments in respect of the acquisition of reversions of property, payments charged on the reversions, were to be made over a period of 10 years. In denying the taxpayer a deduction for purposes of the then United Kingdom excess profits tax, the House of Lords treated the payments as having been made for the reversions. There is an observation by Lord Donovan that “It is true that capital assets may be purchased by income payments; and what the position would be if perpetual rent charges had been the consideration in the present case does not here have to be determined” (at 612). The observation lends support to a view that payments over the whole life of an asset are the more likely to be seen as
payments for the use of the asset. In Ballarat & Western Victoria T.V. Ltd (1978) 78 A.T.C. 4630 payments for the use of a T.V. mast were made in the first five years of a period of entitlement to use that was limited only by the life of the mast and which, it was assumed, would extend for many years beyond the five years. The payments were denied deduction.

7.48 There is another basis of distinguishing Colonial Mutual Life. In that case the building whose use by letting triggered the payments to another, was in part erected on land which was the property of the taxpayer prior to the transaction under which the obligation to make the payments arose and in part on land acquired from the person to whom the payments were made. The taxpayer assumed an obligation in relation to the use of property which he might otherwise have used without payment. A view that the payments were not for the use, but simply payments on use, was for this reason the more likely.

7.49 A series of payments which would be deductible as tolls for the use of an asset may be commuted to a present payment, which may in its amount reflect the fact that payment is made earlier. However the amount is calculated, it will not follow that the payment should have the same character as the payments in a series would have had. An illustration is the payment of interest in advance. The phrase “interest in advance” tends to obscure the significance of the payment. It is a commutation of future payments, and if it secures a substantial immunity from future payments, it may be denied deduction as a payment to acquire a lasting advantage which is structural. The characterisation of interest in advance was the subject of some comment in [6.117]ff. above.

7.50 It may be thought that there is some difficulty in reconciling this view of a payment of interest in advance with authorities concerned with the payment of pensions to retired employees. In Hancock v. General Reversionary & Investment Co. [1919] 1 K.B. 25 an already retired employee accepted an insurance policy, on which his employer had paid a lump-sum premium, in satisfaction of his pension rights. The policy provided for the payment of an annuity. The employer was allowed a deduction of the lump-sum premium. The case was described by Rowlatt J. in Morgan Crucible Co. Ltd v. I.R.C. [1932] 2 K.B. 185 at 195 as “very much on the line”. There is in any case an important difference. If the unfunded superannuation scheme had provided for a lump-sum payment to the employee and a lump-sum had been paid, it would, one may assume, have been deductible. A payment to commute an obligation to pay a pension should not be treated differently. But a lump-sum payment to obtain a loan which is interest free or at low interest where the loan is of substantial duration would be denied deduction as capital. A payment to
commute an obligation to make a series of payments by way of interest should not be treated differently. *J. Gadsden & Co. v. C.I.R.* (1964) 14 A.T.D. 18 may appear to conflict with the views just expressed. A payment to commute an obligation to make periodical payments for the use of knowhow was held deductible. The commutation payment should have taken its character from the character a single sum, being the only payment required by the agreement, would have had. It should not take its character from the payments commuted. A payment in commutation of the payments held deductible in *Cliffs International* should not be held deductible. To allow a deduction of the commutation payment is to encourage the taking of a deduction by employing two steps—an agreement to pay periodical amounts and an immediate commutation—when a deduction would be denied if only one step has been employed. The use which counsel in *Ilbery* (1981) 81 A.T.C. 4661 sought to make of the decision in *Nevill* (1937) 56 C.L.R. 290 was not warranted by that decision. The payment in *Nevill* was not made in commutation of obligations to make future payments of salary, and if it had been, it would have taken its character from the character a single sum, being a payment of salary in advance, would have had. Where a present payment of future salary is made, there are the same prospects that it will be found to be capital as there are where there is a present payment of future interest. The payment secures the advantage of the employee's services without further payment. If the payment is in respect of a number of years of future service, it may be held to give rise to an enduring advantage.

7.51 The cost of acquiring an asset which is structural will be denied deduction as an outlay that is not an outgoing, if the asset is not a wasting asset, or it will, in any event, be denied deduction as a capital outgoing. But circumstances may bring about a change in the character of an asset, so that what was structural becomes a revenue asset. In such circumstances an allowance should be made against the proceeds of sale of the revenue asset to reflect the cost of the asset. The allowance should be the value of the asset at the time it became a revenue asset. If no allowance is made, there is an affront to the principle that an item is not income save where, and to the extent that, it involves a gain.

7.52 A related problem arises where an asset was not acquired as an asset of any business: it was acquired and has been held privately. The asset is now taken into the business as a revenue asset of that business. An illustration may be a car owned and used privately by a second-hand car dealer who now sells the car through his second-hand car sales yard. Another illustration might involve a land developer and dealer who develops and sells in the course of his business land that he has inherited.
In these circumstances it is well established that the taxpayer is entitled to treat the value of the property at the time it is committed to his business as a cost of trading stock. In the United Kingdom there is authority in *Craddock v. Zevo Finance* (1946) 27 T.C. 267. In Australia there is authority in *Bernard Elsey Pty Ltd* (1969) 121 C.L.R. 119 and in the judgment of Gibbs J. in *Curran* (1974) 131 C.L.R. 409, though in the former case the issue concerned the operation of the second limb of s. 26 (a) (now s. 25A(1)) and in *Curran*, as it was submitted in [7.24] above, the principle was misapplied. There is authority, too, in *Official Receiver in Bankruptcy (Fox's case)* (1956) 96 C.L.R. 370.

7.53 The problem of an allowance for the cost of a structural asset that becomes a revenue asset has some affinity with another. A taxpayer may come to dispose of an asset which is held as a non-business asset, or as a structural asset of a business, in a transaction which will yield income receipts as periodical receipts, as royalties or as receipts which compensate for income receipts. At a number of points in Chapter 2 above, illustrations were given, and it was asserted that the denial of any allowance for the cost of the asset offends the principle that income involves a gain. The starkest illustration is that afforded by the facts of *Egerton-Warburton* (1934) 51 C.L.R. 568 ([2.204]ff. above). Another illustration is afforded by *McCauley* (1944) 69 C.L.R. 235 [2.314] above. In these instances the Assessment Act has provisions— in s. 27H and s. 124J— which seek to preserve the principle that income involves a gain, though the inadequacy of s. 27H was revealed in *Egerton-Warburton* and the inadequacy of s. 124J in *White* (1968) 120 C.L.R. 191. The existence of these provisions may inhibit the recognition of a general principle that would allow the subtraction of the value of so much of the non-business asset or structural asset, as is the subject of the transaction which will yield income receipts. In the case of a structural asset, the existence of depreciation and amortisation provisions, which apply to the cost of the asset and provide for balancing charges and allowances, must also inhibit the recognition of a general principle, though those provisions do not assist in the situation of a disposition of the structural asset itself. Depreciation and amortisation provisions are concerned with an allowance for the wasting of structural assets. The allowance is of the cost of the assets as those costs are consumed in a process of income derivation. Such provisions are unhelpful where a structural asset is exchanged for income returns, and, in any event, depreciation and amortisation provisions are less than adequate to cover the occasions where the costs of structural assets are consumed in a process of income derivation. Reference is made in [7.10] above and [7.62] below to a number of occasions where the law is inadequate.
7.54 The specific provisions should not preclude the development of a general principle. Section 82 will protect the Commissioner against any risk of double allowance. Where an asset that was a structural asset and has become a revenue asset is disposed of, the appropriate allowance is the value of the asset at the time immediately before it became a revenue asset. Thus, timber on timber-bearing land may have been held privately, or as a structural asset of a business, up to the time it became a revenue asset. The value of the timber felled, immediately before the felling, is the appropriate allowance against the proceeds of realisation of the timber. Section 124J is inadequate. Its operation depends on actual costs at whatever time the land and the timber were acquired. There may indeed be no cost where the land and timber have been inherited. Where an asset held as a non-business asset, or as a structural asset of a business, is disposed of in a transaction which will yield income receipts (as periodical receipts, royalties or receipts which compensate for income receipts), the allowance should be the value of the asset at the time immediately before the disposition.

7.55 It may be said that the effect of the allowance is to exclude from tax a capital gain that may have accrued between acquisition of the asset and its becoming a revenue asset or its disposition, and that the objective should be the more limited one of ensuring that tax should not be levied on a receipt which does not represent any accretion to economic power. Any objective stands to be obstructed in its achievement by the fact that general income tax law has regard only to realised gains. An allowance of value as a cost may preclude the bringing in of a gain which has already accrued but is unrealised. And it will preclude the bringing in of a capital gain which may have been realised, but not taxed, at an earlier time, and is now represented by the asset. An attempt to exclude this accrued gain, or already realised but untaxed gain, from the value that is to be allowed as a cost, will enmesh the law in what may be an unending tracing back of the asset into forms of wealth previously held which may have generated gains which are now reflected in the asset.

7.56 Where an asset that is not a revenue asset of a business is disposed of for receipts which have an income character, the suggestion is that there should be an allowance of the value of the asset at the time of disposal, to be applied against the proceeds of disposal. It is true that the consequence may be severely to limit the amount that is brought to tax as periodical receipts, royalties or compensation receipts. Indeed, if the value of an asset is simply the present value of the income flows that it will produce, the amount brought to tax will in many cases simply reflect the interest factor, that may arise from any deferment of the receipts beyond the time of realisation.
An allowance of the value of the asset disposed of to be set against the proceeds will raise the prospect of a deductible loss arising where the taxpayer has entered on an unfavourable arm's length transaction, or has dealt with another in a non-arm's length transaction. Such a loss would be within established principles where the asset has become a revenue asset. The allowance of a loss where a non-business or structural asset is disposed of for proceeds which are income would break new ground.

Where the asset has been the subject of depreciation or amortisation deductions under ss 54ff. or Div. 10B of Pt III, there will be need to correlate the operation of the principles now proposed with the balancing allowance or charge provisions. In the case of depreciation the correlation would be straightforward. In the case of amortisation under Div. 10B, it would be the more difficult. It will be seen in [10.235]–[10.269] below that the operation of Div. 10B is not clear where there has been a partial disposition of an item of commercial or industrial property for receipts which are income as periodical receipts, as royalties or as compensation receipts.

There will be occasions when the proceeds of realisation of a nonbusiness or structural asset will include both income and non-income elements. A sale of standing timber that is a structural asset may be for a lump sum and for amounts that are royalties. It will be important to confine any allowance to a fraction of cost determined by the ratio which the income element in the proceeds bears to the total proceeds.

The discussion so far has glossed over the problems that lie in the notion of proceeds of realisation. It will be evident, in the case of timber, that a McCauley agreement involves a realisation of an asset, though too much regard for rationalisation of the notion of royalties as receipts “for the use” of an asset may obscure this reality. It would be equally true of a McCauley (1944) 69 C.L.R. 235 agreement applied to sand gravel or blue metal presently part of land. The grant of a licence in respect of an item of commercial or industrial property which has a limited life (which would exclude a trade mark) will generally be a disposition of property, though there might be some difficulty in so regarding it where the licence is not exclusive. Clearly there must be problems in fixing the extent of the realisation and any allowance must be related to the extent of the realisation.

The Characterisation of Expenses where no Structural Asset is Acquired

In John Fairfax & Sons Pty Ltd (1959) 101 C.L.R. 30 at 36 Dixon C.J.
said:

“It is not in my opinion right to say that because you obtain nothing positive, nothing of an enduring nature, for an expenditure it cannot be an outgoing on account of capital. What Viscount Cave L.C. said in British Insulated and Helsby Cables Ltd v. Atherton [1926] A.C. 205 was this, ‘But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital’ [1926] A.C. at 213, 214. That is an affirmative proposition. But is is hardly necessary to say that it is a logical fallacy to turn it round and say that an expenditure cannot be attributable to capital unless it is made once for all and is made with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade. Nor did Viscount Cave L.C. mean to say that no expenditure falling outside his proposition could be of a capital nature. No doubt it is not often that an outgoing is voluntarily incurred without anything to show for it. The cynical might say that it is a phenomenon so rare that for illustrations of such an outgoing you must look to the costs of litigation. It is however a feature that is always likely to occur when the purpose of the expenditure is to limit or buy off opposition or forestall or get rid of some present or threatened disadvantage. Of course you can have expenditure of that kind which on the soundest principles of accounting is chargeable against revenue. But you might confidently expect to find that much expenditure of the kind was undeniably on capital account.”

7.62 Clearly an expense whose object is the enlargement of structure will be capital notwithstanding that it does not in fact result in any increase in structure. The expense may be unsuccessful. There is United Kingdom authority that will support a proposition of that kind: Southwell v. Savill Bros Ltd [1901] 2 K.B. 349; Pyrah v. Annis & Co. Ltd [1957] 1 W.L.R. 190; and more recently ECC Quarries Ltd v. Watkis [1975] 3 All E.R. 843. At the same time, there is a disposition in United Kingdom authorities to commit the “logical fallacy” to which Dixon C.J. refers in the passage quoted and turn the dictum of Viscount Cave round by saying that an expense cannot be attributable to capital unless it is made once and for all, and is made with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade. Southern v. Borax Consolidated Ltd [1941] 1 K.B. 111 and Morgan v. Tate & Lyle Ltd [1955] A.C. 21 reflect such a disposition. In John Fairfax & Sons Fullagar J. drew attention to the fact that Southern v. Borax Consolidated Ltd had been rejected by four judges of the High Court in Broken Hill Theatres Pty Ltd (1952) 85 C.L.R. 423, as a decision that “cannot be supported”. Southern v. Borax Consolidated had already been rejected by Dixon J. in Hallstroms Pty Ltd (1946) 72 C.L.R. 634 in a dissenting opinion that was approved by the
majority of the High Court in *Broken Hill Theatres*. There is thus some basis for saying that United Kingdom law on the matter of capital outgoings has come to differ from the Australian law, and United Kingdom authorities may need to be received with caution. The Australian law may none the less be thought the less desirable as a matter of policy. Where an expense gives rise to a structural asset that is a wasting asset, there may be available depreciation or amortisation provisions which will provide for deductions. Where no asset is acquired, or the expense does not relate to a wasting structural asset in a way that attracts the available depreciation or amortisation provisions, the expense, though consumed in a process of income derivation, will at no time be deductible. The expenses in *Broken Hill Theatres* were at no time deductible. The expenses in *Foley Bros Pty Ltd* (1965) 13 A.T.D. 474, 562 were at no time deductible, though in that case the unavailability of deductions might be justified on the ground that the expenses related to goodwill which does not waste. The expenses of defending structure considered in [7.66]ff. below may not be seen as expenses related to a structural asset justifying the application of depreciation or amortisation provisions, and any relevant structural assets may not, in any event, attract such provisions.

**Expenses of effecting a change in structure**

7.63 A rejection of the logical fallacy that would be involved in turning the dictum of Lord Cave round, is most evident in the Australian authorities in the decision of the High Court in *Foley Bros Pty Ltd* (1965) 13 A.T.D. 474, 562. The taxpayer had paid an amount to a United Kingdom company to obtain release from an obligation not to scale down—discontinue in part—its Australian operations. Thereafter the company shut down a number of its branches in Australia. The High Court held the money paid to secure the release from the obligation was a capital outgoing. Kitto, Taylor and Menzies JJ., affirming the decision of McTiernan J., said: “It is a fundamental error to treat a freedom to dispense with whole branches of a widespread enterprise as if it were only a freedom to move the goods in a shop from one counter to another. The true contrast is between altering the framework within which income producing activities are for the future to be carried on and taking a step as part of those activities within the framework.”

7.64 Whether or not the contract, release from which is obtained by a payment, is an aspect of structure, or “framework” in the language of *Foley Bros Pty Ltd*, must depend on considerations examined in the discussion in Chapter 2 above of *Van den Berghs* [1935] A.C. 431 ([2.489] above) and
the agency cases ([2.485]–[2.486] above). It would, for example, be wrong to draw a conclusion from *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290 that a payment to obtain release from a service agreement with a managing director is always to be seen as concerned “with the ever recurring question of personnel”. That phrase is used in *Nevill* (at 306) by Dixon J. to describe the payment made to the managing director. Where the managing director is employed, as in *Bennett* (1947) 75 C.L.R. 480, under a contract which gives him wide and exclusive powers over the employer's business, it is possible to treat the contract as one going to structure, and to deny a deduction of a payment to obtain release from the contract.

**7.65** *Anglo-Persian Oil Co. Ltd v. Dale* [1932] 1 K.B. 124 is consistent with Australian law only if the agency agreement is seen as one that was less than fundamental. A payment which put an end to an agency agreement through which the taxpayer had carried on its business in the Middle East, was held deductible. All judgments in the Court of Appeal emphasised that there was no enduring benefit resulting from the discontinuance of the agency. There is thus some ground to suggest that the decision was moved by Dixon J.'s “logical fallacy”. There is however an indication of a basis of decision acceptable in Australian law, in the description of the payment in the judgment of Lord Hanworth M.R. as one made to “put an end to an expensive method of carrying on the business”. There is a possible distinction to be drawn between structure within which a business is carried on and a method of carrying on the business.

**Expenses of defending as distinct from maintaining structure**

**7.66** It is in the area of what may be called defence expenditure that differences between the United Kingdom and the Australian law become most apparent. Expenses of defending one's business against compulsory acquisition by another might be thought very obviously to go to structure, if the “logical fallacy” arising from *British Insulated & Helsby Cables Ltd* [1926] A.C. 205 is rejected. *Morgan v. Tate & Lyle* contrasts with *Ward v. C.I.R. (N.Z.)* (1968) 15 A.T.D. 196 and, in Australia, with *John Fairfax & Sons Pty Ltd* business operations. The occasion, moreover, was special. The same observations (1959) 101 C.L.R. 30. In the latter case a view of the facts which would see the expenses as costs of acquiring the shares in the company taken over was not excluded by any member of the court. At the same time it was agreed that the expenses were capital even if seen as expenses of defending title to shares already acquired. It may indicate the fortuitous consequences that follow from the logical fallacy, that its application would have justified the frantic efforts of the taxpayer in the
early hours of Monday morning to ensure that acquisition of the shares was complete before any legal proceedings could be taken to challenge the acquisition.

7.67 The range of expenses that may be called defence, in any proposition that expenses of defence of structure are capital, is however limited. In Hallstroms Pty Ltd (1946) 72 C.L.R. 634 the grant of the extension of a patent would have imposed significant limitation on the taxpayer's planned might be made in regard to Broken Hill Theatres Pty Ltd (1952) 85 C.L.R. 423. The grant of a licence to a competitor to operate a picture theatre would have significantly threatened the taxpayer's goodwill, and the occasion of threat was special. In Broken Hill Theatres the legal expenses of opposing the grant were denied deduction. Broken Hill Theatres approved the dissenting judgment of Dixon J. in Hallstroms, where he had taken the view that the expenses of opposing the grant of the extension of the patent were capital.

7.68 Some expenses will be outside the notion of defence expenditure. They may be called maintenance expenses and may be deductible. In this instance it is the recurrence of the expenses of the class to which the expense belongs which precludes a conclusion that the expense is capital. Recurrence is recognised as a relevant factor in the formulation of matters by Dixon J. in Sun Newspapers Ltd (1938) 61 C.L.R. 337. In Snowden & Willson (1958) 99 C.L.R. 431 the class to which the expense belonged was on-going expenses of obtaining payment from customers. A failure to resist the challenge to the company's business operations which was involved in the inquiry by the Royal Commission would have led to refusals by customers to pay instalments under contracts they had entered, and to challenge those contracts. The expense is of a class of acts which may be described as acts in carrying on the operations whence income is derived. The fact that in some sense they relate to structure does not displace their character as working expenses. A premium for insurance of factory premises against fire is deductible as a working expense.

7.69 In the discussion in [6.17]ff. above it was suggested that unusualness which may not deny the character of relevance to an expense may yet deny an expense a working character. Where the question is simply one of relevance, it may be appropriate to treat an event as one of very broad class of events which are “ever-recurring”, as Dixon J. did in W. Nevill & Co. Ltd (1937) 56 C.L.R. 290. Where the question is whether an expense is a working, as distinct from a capital, expense, it may have to be seen as one of a narrower class of events that are not fairly described as “ever-recurring”. Expenses of defence which are structural will relate to a special challenge to the continuance of a business or the holding of property
whence income is derived. It may be appropriate to refer to them as expenses of defence in a situation of peril, though the word “peril” may be too limiting. It is enough that a significant element of a taxpayer's business operations are the subject of some special challenge. Expenses of a builder in resisting an action brought by a customer will generally be working expenses. But expenses of appearance in proceedings brought by a licensing authority to deregister the builder may well be non-working. In Snowden & Willson the High Court expressly negatived a view of the facts that would have seen the appearance before the Royal Commission as a matter of defence in a situation of peril.

7.70 In a Snowden & Willson situation a distinction between revenue and capital outgoings in terms of acquisition of structure, change in structure or defence of structure becomes unhelpful. An actual increase in goodwill or an increase in capacity to engage in operations from which income may be derived, which may result from a payment, will not deprive it of a revenue character if the payment is made in meeting circumstances which are an on-going experience of the business. Expenses of advertising, though directed to increasing goodwill as well as maintaining it, are a response to the on-going need to hold and if possible increase the goodwill of a business.

7.71 Expenses which are incurred in the on-going effort of a business to break through the commercial and legal limitations to which it is subject may be working expenses, even though success may bring an increase in structure, and even though they may be seen as directed to that increase in structure. An illustration of a commercial limitation is the present range of goodwill of a business. An illustration of a legal limitation may be hours of trading to which a business is subject (Cooper v. Rhymney Breweries Ltd [1965] 1 W.L.R. 1378), or quota restrictions on import, or export, or on manufacture, to which a business is subject.

7.72 The significance of “recurrence” in the more restricted meaning the word carries where the question is whether an expense is a working expense supports the view taken in this Volume that the exception of losses or outgoings of a capital nature in s. 51(1), like the other exceptions in the subsection, is not a true exception. Deductibility depends on an expense being relevant to the derivation of assessable income and on its being a working expense. In whatever way losses or outgoings of a capital nature are identified in other respects, only one basis of identification is significant: a capital expense is a non-working expense.

**Expenses that are Irrelevant: Losses or Outgoings of Capital**
7.73 It will be noted that s. 51(1) makes a distinction between “losses or outgoings of capital” and “losses or outgoings of a capital . . . nature”. So far in this chapter references to capital losses and outgoings are references to those that may be covered by the latter form of words. “Losses or outgoings of capital” may have a distinct meaning. That meaning cannot depend on the source of money that has been used in the making of the outgoing. A doctor who sells a car used in his practice and uses the proceeds of sale in the making of payments that would otherwise be deductible should not be denied deduction of those payments. The meaning could identify distributions made by a business to its proprietors. Other illustrations would be a payment by way of a return of capital made by a company to its shareholders. In this illustration company law language would accord with the tax language. Another illustration might be a dividend paid by a company, in which case company law language and tax language would diverge. Yet another illustration might be the appropriation of assets of a business by one of its proprietors, as in Ash (1938) 61 C.L.R. 263 or in Curtis v. Oldfield (1925) 9 T.C. 319 at least in the explanation of those cases given in [6.71]–[6.73] above. In none of these illustrations would the exception of losses or outgoings of capital operate as a true exception. In all the illustrations the outgoing would fail to qualify as a relevant expense: the outgoing is not incurred in gaining income, it is an application of income derived.
Chapter 8: Expenses that are Irrelevant: Private or Domestic Expenses

8.1 The heading now adopted makes an assumption about the framework of s. 51 which has been explained in earlier paragraphs. None of the capital losses and outgoings exception, the private losses and outgoings exception and the domestic losses and outgoings exception is a true exception. An expense is capital if, though relevant, it is not a working expense. An expense is private or domestic if it is not a relevant expense. The assumption comes under some challenge from the High Court decisions in Forsyth (1981) 148 C.L.R. 203 and Handley (1981) 148 C.L.R. 182 but it is not definitively rejected, and, it will be seen the reasons for judgment in those cases highlight the difficulties of analysis which any contrary assumption involve. The challenge is to be found in the judgments of Mason, Wilson and Murphy JJ. It is not found in the dissenting judgments of Stephen and Aickin JJ., who were at some pains to discount the significance of any challenge that might be found in earlier cases.

8.2 In [5.8] above the assertion was made that there is no case in which an expense has been found to be incurred in gaining assessable income, but has been denied deduction as a capital expense. It may also be asserted that there is no case in which an expense has been found to be incurred in gaining assessable income, but has been denied deduction as a private or domestic expense. Forsyth and Handley do not destroy the latter assertion, and this has a bearing on the observations made in the case on the significance of the capital and private and domestic exceptions. A view that the exceptions have a function of denying the deduction of outgoings that are otherwise deductible would be the more persuasive if it were supported by an illustration of their operation in that function.

8.3 Mason J. in Handley said (at 194): “outgoings incurred in gaining or producing assessable income and outgoings of a capital or domestic nature are not mutually exclusive. Whether the same is true of outgoings of a private nature is a question that may be left to some future occasion.” One would have thought that domestic outgoings are but a class of private outgoings, and that Mason J. had to a degree already taken a view in the earlier part of his statement on the question he has left for a future occasion.

8.4 In Forsyth, Wilson J. (at 216) referred to a comment by Menzies J. in Hatchett (1971) 125 C.L.R. 494 at 498 that “it must be a rare case where an outgoing incurred in gaining assessable income is also an outgoing of a private nature. In most cases the categories would seem to be exclusive”.

Wilson J. expressed his ready acceptance of that proposition, but expressed the opinion that it was not “necessarily true of outgoings of a domestic nature”. Unless it is to be claimed that there are some domestic expenses which are not private, the agreement with Menzies J. and the opinion expressed in regard to outgoings of a domestic nature cannot stand together. In the same passage in his judgment, he expressed the view that an outgoing may be incurred in gaining assessable income and yet be an outgoing of a capital nature, and drew support from Hatchett where Menzies J. said:

“Section 51 does recognise that there will be outgoings incurred in gaining or producing income, or in carrying on a business to do so, that are of capital or of a capital nature. Expenditure of this sort is commonly made. Thus, for instance, a taxpayer who is a baker, who buys a van to deliver bread to his customers, makes such an outlay…” (Forsyth (1981) 148 C.L.R. 203 at 216).

The quotation from Menzies J. is the nearest the law reports offer of an illustration of an exception operating to exclude. Perhaps Menzies J. did not intend it to be an illustration. It is, in any case, not an illustration that can be accepted. The purchase of plant is not a working expense of a baker's business. None of “working”, “incidental”, “constant demand”, “operating” or “maintenance” would describe it.

8.5 Murphy J. in Handley (1981) 148 C.L.R. 182 at 196 was content to assert that “the section contemplates that an outgoing incurred in gaining assessable income may not be an allowable deduction because it is of a domestic nature”, and to direct attention to circumstances which he thought yielded a conclusion that the outgoings in question were of a domestic nature.

8.6 Stephen J. in Handley (at 192), after an observation that the exception of private or domestic outgoings had not been the subject of close examination by any court, inclined towards a view that the exception of private or domestic outgoings, like the exception of outgoings related to exempt income, could be explained in the words of Ronpibon Tin N.L. & Tongkah Compound N.L. (1949) 78 C.L.R. 47 at 56 as securing the “not unimportant purpose of making an express contrast”. Aickin J. took a more positive stand (at 200): “The express exclusion in the closing words of the subsection of expenditure of a private or domestic nature has the same character as the exclusion of expenditure in gaining exempt income; it must be regarded as having been inserted by way of precaution or emphasis…”

8.7 An excluding function for the private or domestic exception would require the adoption of a view that expenses that are private or domestic are to be denied deduction, however relevant to the derivation of assessable income they may be. This would in turn require the defining of private or
domestic expenses in terms that do not let in considerations of relevance to the derivation of income. Such a view may be possible, but it would make little sense. Eating, drinking, clothing oneself, sleeping and enjoying shelter would be prime candidates for categorising as matters that are absolutely private or domestic—absolutely in the sense that they are such whatever their relevance to income derivation. If they are so categorised it would follow that the cost of the business lunch, the cost to the actor of refreshments taken in actual performance of the Mad Hatter's Tea Party (Templeman J. in Caillebotte v. Quinn [1975] 1 W.L.R. 731 at 733), the costs of meals and accommodation incurred by a commercial traveller while travelling on business, and the costs of protective clothing incurred by a taxpayer working in industry are not deductible.

8.8 There is no doubt a need to protect the base of the income tax against a too-ready allowance of deductions which may reduce the base to a point where the income tax becomes a tax on income saved. An imaginative mind will find some relevance to income derivation in any expense. Eating sustains a taxpayer's ability to work and derive income, and to this extent the expense of eating is always relevant to the derivation of income. The law must insist that there be a “sufficient” connection between an expense and income derivation, and sufficiency imports questions of degree which must always leave room for judgment. But it is preferable to live with the questions of degree, than to attempt via notions of matters that are absolutely private or domestic, or “essentially” private or domestic in the language of Forsyth and Handley, to maintain restraint in the allowance of deductions.

8.9 It is proposed to deal with a number of areas where the private and domestic exceptions have been emphasised in reasons for decision. In the view of this Volume, all the decisions are concerned with fixing the point where connection with a process of income derivation is sufficient to make an outgoing relevant.

Food, Clothing, Health, Shelter and Child care Expenses

Expenses of food

8.10 Some connection with a process of income derivation, at least with a process of deriving active income, can be claimed for all of food, clothing, health, shelter and child care expenses. At the lowest level it will be a connection of the kind that is involved in an assertion that one must live to work and one must eat to live. Clearly an income tax could not accept such a connection as a sufficient connection to make the expenses of food
relevant. At the highest the connection may be of the kind that links one's own lunch eaten in company with a client when business is transacted, with the carrying on of the business, or links expenses of tasting food incurred by a taxpayer who carries on a business of providing advice to consumers. One would expect there to be no argument about sufficiency of connection in these instances; though at intermediate levels decision will involve judgment, and may reflect a policy that the base of the income tax needs to be protected. It would be assumed that the self-employed is entitled to the cost of his meals while travelling on business, but not to the cost of his lunch if he is presently working at his base. It would be assumed that the employee commercial traveller may expect the same treatment, and that the cost of an employee's evening meal does not become deductible because he has been asked to work overtime.

8.11 It does not assist the rationalisation of these consequences to say that eating is absolutely or essentially private, and is excluded from deduction by the exception of private outgoings. If eating is essentially private, no deduction will be allowed of the cost of meals in any circumstances. If it is said that eating is essentially private unless there is a sufficient connection with a process of income derivation, the exception is without any function. It simply restates the requirement of relevance. An illustration of an expense of eating that is relevant and deductible, beyond the expenses of the tea consumed by the actor in the Mad Hatter's Tea Party (Templeman J. in Caillebotte v. Quinn [1975] 1 W.L.R. 731 at 733) is afforded by Cunliffe (1983) 83 A.T.C. 4380. The taxpayer was in business as a restauranteur and ate meals in restaurants overseas in the course of studying techniques of preparing, presenting and serving meals in those restaurants. Expenses of some meals were held deductible, notwithstanding that there must have been a purpose to satisfy a need for food as well as the purpose of gaining knowledge. Presumably the study purpose was seen as dominant. An apportionment so as to disallow a part of the expense would not have been appropriate. On the view taken in this Volume ([9.1]ff. below), an apportionment would only have been appropriate if distinct payments might have been made in respect of the nourishment and enjoyment afforded by the food, and a distinct payment for the experience of testing its quality. Clearly distinct payments could not have been made. Which is not to say, in relation to some meals, study could not be found to be subordinate to nourishment and enjoyment. The court in Cunliffe concluded that the expenses of some of the meals should be denied deduction. Judgments of this kind about the facts are, no doubt, banal, but they are unavoidable in the application of the relevance principle.

8.12 In White (1975) 75 A.T.C. 4018 the taxpayer incurred expenses in
relation to a course of study. The case is considered again in [8.43]-[8.46] below. The taxpayer was allowed a deduction by a Board of Review of the travel expenses involved in attending the school, but denied a deduction of the cost of meals he had to buy away from home because of the need to travel to the school. He did not appeal against the denial of the meal costs, though the Commissioner successfully appealed against the allowance of the travel costs. The cost of meals taken during working hours at one's normal place of work will generally be non-deductible. An appropriate test would insist that the costs of meals cannot be relevant if the taxpayer might have been expected to sustain himself on food brought from home. There will none the less be marginal cases, such as the cost of a meal when a taxpayer works overtime. The meal expenses in *White* are another marginal case.

**Expenses of clothing**

8.13 Some attempt has been made, in relation to clothing, to set a test of sufficient connection in phrases such as “necessary and peculiar”, which will allow a deduction of the costs of protective clothing worn while engaged in a process of income derivation, and of the costs of the uniform worn by a barrister or judge, unless the costs are to be regarded as not working, in which event depreciation may be allowed. At intermediate levels are the costs of clothing which is not necessary and peculiar but is worn by the taxpayer only while engaged in a process of income derivation—the sombre suit or dress worn by a barrister beneath the uniform (*Mallalieu v. Drummond* (1981) 1 W.L.R. 908). The clothing expenses of a “plain-clothed” detective might however be thought to be at a level which could not attract deductions (cf. *Hillyer v. Leeke* (1976) 51 T.C. 90).

8.14 It would be possible to treat differently the cost of cleaning clothing, and the cost of the clothing itself. Where the need for cleaning of clothing that is not necessary and peculiar is the more frequent because of the conditions experienced in the process of income derivation, the costs of cleaning could be treated as relevant. The element of connection is, however, tenuous (cf. *Ward v. Dunn* (1978) 52 T.C. 517).

**Health costs**

8.15 There is no Australian judicial decision on the deductibility of health costs. Prior to 1975 health costs might have attracted concessional deductions and, save where the taxpayer sought to establish a loss available for carry forward, there was no call to assert a s. 51 deduction. Health costs
may now be included in the concessional rebate expenditure that can give rise to a rebate of tax. But there is clearly a greater advantage to the taxpayer if health costs are deductible under s. 51(1).

8.16 The relevance of United Kingdom decisions on the deductibility of health costs to the question of deductibility under s. 51(1) is limited by provisions (s. 130(a) and (b) of the Income and Corporation Taxes Act 1970) of the United Kingdom legislation which require that an outgoing to be deductible must be “wholly and exclusively laid out for purposes of the trade, profession or vocation”, and which deny a deduction for expenditure “for maintenance of” the taxpayer “or for any other domestic or private purposes distinct from the purposes of the trade, profession or vocation”. Those provisions are relied on in Norman v. Golder [1944] 1 All E.R. 632 and Prince v. Mapp [1970] 1 W.L.R. 260 for a view that where there are two purposes in incurring health costs—“the advantage and benefit of the taxpayer as a living human being” and the advantage of the trade profession or vocation—a deduction must be denied. Australian law does not include provisions of the kind included in the United Kingdom legislation. Expenses that have two purposes may be apportioned in Australia between those purposes, and a deduction allowed of that amount that relates to the purpose which attracts deductibility. Which is not to say that Australian law would treat the two purposes situation involved in Norman v. Golder as one that could involve apportionment. The primary question is always whether the expense is relevant. The outgoing in Magna Alloys & Research Pty Ltd (1980) 80 A.T.C. 4542 would not have been the subject of an apportionment if it had been concluded that the payments were made for mixed purposes of securing the company's interest and of conferring a gratuitous benefit on the directors. An apportionment would only have been proper in these circumstances if a distinct outgoing might have been incurred in serving the company's interest and another in conferring the benefit. The existence of two purposes, only one of which favours a conclusion that an expense is relevant, does not preclude a conclusion that the expense is relevant. But there is no room to express a doubt about the sufficiency of connection between an expense and income derivation, and thus its relevance, by allowing a deduction of only part of the expense.

8.17 A view that health costs are private in essential character and are denied deduction by the private outgoing exception in s. 51(1) might be asserted. In this, as in other contexts, however, an analysis which would assign an excluding function to the exception is unacceptable. If costs of protective clothing are not excluded by the private outgoing exception, the costs of protective medicine, if they are specific to the hazard against
which protection is sought—perhaps a protective cream applied to the skin—should not be excluded. And if the cost of protective medicine is not excluded, the cost of treatment of some condition caused by working should not necessarily be excluded. What view should be taken of the cost of treatment of ill-health caused by engaging in a process of income derivation depends on the degree of connection with income derivation that is required in this context. There is much to be said for holding that a degree of connection which depends on the ill-health having been caused by engaging in a process of income derivation is insufficient. To adopt a notion of cause by the activity of income derivation is to let in problems of cause which will make for an unacceptable complexity in the administration of the law. In *Norman v. Golder* the taxpayer claimed that his ill-health had resulted from unfavourable working conditions. The Court of Appeal escaped the need to decide whether this justified deduction of the medical expenses by pointing to a duality of purpose, and to the provisions of the United Kingdom legislation to which reference has already been made.

8.18 There is some suggestion in the judgment of Pennycuick J. in *Prince v. Mapp* [1970] 1 W.L.R. 260 that medical expenses incurred in the restoration of a specific bodily function that is necessary for the process of income derivation in which the taxpayer is engaged could attract deductibility. If it had appeared that the only purpose of the taxpayer in having the finger tendon repaired had been to enable him to play the guitar professionally, Pennycuick J. would have allowed a deduction of the expense of the surgery involved. A test of sufficient connection for purposes of s. 51 which would allow the deduction of medical expenses in these circumstances may be thought unacceptable. In the circumstances of *Prince v. Mapp* the expense may be thought specific, and the expenses of treating influenza not to be. But what view should be taken of the cost of spectacles for a person with defective sight? The latter question ranges into areas beyond the medical, though areas where the issues of relevance have their parallels. What view should be taken of the cost of an attendant without whom a paraplegic could not travel on business? In *Gilbert* (1982) 82 A.T.C. 141 a quadraplegic was denied a deduction in these circumstances. What view should be taken of the cost of keep fit classes undertaken by an airline pilot?

8.19 If relevance is accepted, a question of working character of the outgoing will in some cases remain. It is arguable that an expense is not a maintenance expense if a correction of a substantial disability is involved: it is an expense of acquiring structure—capacity to engage in a process of income derivation. A line of argument of this kind, advanced in relation to
self-education expenses, was however rejected in *Finn* (1961) 106 C.L.R. 60; in *Hatchett* (1971) 125 C.L.R. 494; and in *White* (1975) 75 A.T.C. 4018.

8.20 “Medical expenses”, as defined, may generate a rebate of tax under ss 159N and 159P. If a medical expense is deductible under s. 51(1), there is a question of how the concessional rebate provisions are to be correlated with s. 51(1). There is no provision which expressly precludes the allowance of a concessional rebate expenditure and the deduction of that same expenditure under s. 51(1). Section 159M only applies to double rebates. Section 82 applies only to double deductions. It will be seen, however, that s. 82A deals expressly with the correlation of concessional rebate expenditure and s. 51(1) deduction where the expenditure qualifies as “self-education” expenditure.

**Expenses of shelter**

8.21 The majority judgments in *Forsyth* (1981) 148 C.L.R. 203 and *Handley* (1981) 148 C.L.R. 182 came close to asserting that the expenses of shelter are excluded from deductibility by the domestic exception in s. 51(1). It is true that the cases concerned shelter in accommodation that was, architecturally, a part of the taxpayer's home, and the majority judges were in any case persuaded that the expenses were not sufficiently connected with the taxpayer's income earning activity to be relevant.

8.22 A view that shelter for the taxpayer's person is essentially private or domestic and excluded by the exceptions, is obviously unacceptable. It would require denial of the deduction of the expenses of commercial office accommodation. Where the view is put in a more limited form, so as to confine the notion of essentially private or domestic shelter to that which is insufficiently connected with a process of income derivation, the question of deductibility is returned to the domain of relevance where it belongs.

8.23 Tests of relevance in regard to costs of shelter used as a study are examined below. These tests of relevance are inevitably concerned with the use that is made of the shelter, in effect the activities of the taxpayer while sheltered. Where relevance cannot be established by the use made of the shelter, a test of sufficient connection that will give relevance is not easily found. Some reference was made above to the question of relevance that arises in regard to the expenses of meals eaten by a taxpayer who is required to travel in the course of his business or employment. Deductibility of the cost of accommodation will follow the cost of meals. Deductibility of the costs of meals and accommodation while travelling in the course of one's business or employment away from home, must rest on
a view that the expenses are the consequence of being required by the demands of the income-earning activity to be away from home. Such a view assumes that the taxpayer has a home. The circumstances of a taxpayer who does not maintain a home while travelling on some extended assignment in connection with his business or employment does not fit easily with that view.

8.24 A taxpayer may have a home which is close to one place of work. At the same time he has another place of work so far removed from his home and the first place of work that he must have accommodation while he works there. Those costs are presumably relevant and deductible, at least when the second place of work is within the same business or employment as the first. If it is a place of work within a distinct business or employment there is some room to argue that the costs of accommodation are a consequence of his having his home too remote from the second place of work. That argument can be made more strongly if he has only one place of work, albeit work that engages his attention for what may be only a short period in any year of income and, indeed, is for one period only: 

Charlton (1984) 84 A.T.C. 4415. And there is always a possible argument that he has established another, albeit a temporary home, in the accommodation he occupies while working at the second place, and the costs of accommodation at home are not deductible. That argument may not be available as long as he can be said to maintain the original home.

Child minding expenses

8.25 A taxpayer may have no reasonable alternative to employing a babysitter for his child or paying to have his child minded while he is engaged in an activity directed to earning income. It may be said that the costs involved are an “essential prerequisite to the derivation of that income” from that activity (Mason J. in Lodge (1972) 128 C.L.R. 171 at 175). Yet the degree of connection with the derivation of income is no closer than that between the costs of eating and being able to work. Nor is it closer than the connection between the costs of employing another to look after an elderly relative who is in the taxpayer's care, and the income-earning activity which the taxpayer is released to carry on. Nor is it closer than the connection between the costs of employing labour to do the domestic chores and income-earning activity; the taxpayer will assert that because of that income-earning activity he has no time to do the chores himself.

8.26 In Lodge, Mason J. denied a deduction of child care expenses, emphasising the word “in” as it appears in s. 51(1) and referring to a like
emphasis given by Megarry J. to the same word in a provision of the United Kingdom Income Tax Act 1952 (Sch. 9, para. 7). Megarry J. denied a deduction of child care expenses in Halstead v. Condon (1970) 46 T.C. 289. The United Kingdom provision related to an employee taxpayer and required that the expense should be “in the performance” of the employment. The taxpayer who was a widower, had employed a child minder to look after his two children while he went to work. Megarry J. said: “In no conceivable sense can the expenditure be said to have been incurred by him ‘in’ the performance of his duties: it had nothing to do with the way in which he performed his functions as a clerk . . . ” (at 293). The emphasis on the word “in” foreshadows the analysis that Mason J. adopted in Lodge (1972) 128 C.L.R. 171 that child care expenses, because of their “essential character”, are not incurred in gaining income—an analysis in turn suggested by the judgments of the High Court in Lunney (1958) 100 C.L.R. 478.

8.27 In Lodge (1972) 128 C.L.R. 171, Mason J. decided against a taxpayer on the ground that the expense was not incurred in gaining income. The “essential character” analysis in this context is not concerned with any distinct operation of the exception of private or domestic expenditure. At the end of his judgment Mason J. said: “To this point I have not considered the question whether the expenditure was of a ‘private or domestic nature’. The relationship between the operative parts of s. 51(1) and this exception has not been discussed at length. In this case the arguments were directed to the operative provisions rather than to the exception . . . However, I should express my view that the expenditure was of a private or domestic nature and for that reason is excluded by s. 51(1). In so saying I should make it clear that my view is consequential upon the earlier conclusion that the expenditure falls outside the general provisions of s. 51(1) . . . ” (at 176). These observations accord with the view of the framework of s. 51(1) adopted in this Volume: a finding that an expense is private or domestic is no more than a way of stating a conclusion that an expense is not incurred in gaining income because it is not sufficiently connected and thus is not relevant. It will be seen that in Forsyth (1981) 148 C.L.R. 203 and Handley (1981) 148 C.L.R. 182 there are times when the phrase “essential character” in the judgments of Mason and Wilson JJ. shifts in function, so that it appears not simply to be an identification of some expenses which are not incurred in gaining, but an identification of expenses which, if they are incurred in gaining, are denied deduction because of the operation of the private or domestic exception. A deduction of child care expenses was denied by the Federal Court in Martin (1984) 84 A.T.C. 4513 on the ground of want of relevance, and on the authority of Lodge.
Home Study Expenses

8.28 No area is more productive of debate about relevance than home study expenses. The differences of view in the judgments in Forsyth (1981) 148 C.L.R. 203 and Handley (1981) 148 C.L.R. 182 are not differences of the kind that one must expect where a decision has to be made in regard to an expense at the margin of relevance to the derivation of income. They are more fundamental. Stephen and Aickin JJ., the dissenting judges, were persuaded that in each case it was clear that the expenses were incurred in gaining income—that they were relevant—and, if the exception of private or domestic expenses has any operation, the expenses were not private or domestic. Mason, Murphy and Wilson JJ., the majority judges, were, on the other hand, equally persuaded in each case that the expenses were not relevant because their essential character was private or domestic and, in any event, if the exception of private or domestic expenses has any operation, they were denied deduction because their essential character was private or domestic. In the latter respect, the essential character notion shifts in function.

8.29 The references in the majority judgments to Lunney (1958) 100 C.L.R. 478 as support for an essential character analysis take Lunney further than the High Court intended in that case. In Lunney the “essential character” analysis is used to determine the relevance of an expense, and it may have support in the language of s. 51(1) in its use of the word “in”. But Lunney is not authority that an expense that is relevant may be denied deduction because its essential character is private or domestic.

8.30 The use of the “essential character” analysis by the majority judges in Forsyth and Handley on the question of relevance may be thought to be, in any event, inappropriate. Home study expenses are distinguishable from expenses of travel to work, or food or child care expenses. A definitive characterisation by relying on the word “in” in s. 51(1) is not open. If they are otherwise relevant interest, rent, rates and taxes and insurance premiums relating to a home study are as much incurred “in” gaining income as are the same expenses relating to factory premises.

8.31 One can accept the “essential character” analysis in the context of home study expenses only if it is a way of expressing a policy conclusion that expenses of this kind should not be deductible because the operation of any test that would allow deduction is likely to be administratively unacceptable.

8.32 Any search for an analysis of the deductibility of home study expenses must begin with the authorities that would determine the deductibility of interest on money borrowed and invested in property, and
of rates, insurance, repairs and other overheads, by reference to the use that is made by the taxpayer of the property: those authorities include the Federal Court decision in *Ure* (1981) 81 A.T.C. 4100 and the High Court decision in *Munro* (1926) 38 C.L.R. 153. In *Faichney* (1972) 129 C.L.R. 38 the analysis adopted by Mason J. offered the prospect of a satisfactory determinateness, and a limitation on deductibility, by insisting that the use of the property must be a non-domestic use if the overheads are to be deductible. It is not enough that the taxpayer works at home because working at home may yet be a domestic use. Every taxpayer works at home, even if it is only to worry to a degree about problems of work. Most will do more than that, but any test in terms of degree to which his thinking, writing, typing and filing are directed to issues of his work is administratively impossible to apply, even if the test adds a requirement that one may have regard only to the thinking, writing, typing and filing that is done in a distinct place, presumably not his bed, and that he does nothing else in that distinct place. Working at home will not be a domestic use when the adaptation of the accommodation in which he works and aspects of the work he does, or the contact with others that he makes there, demonstrate objectively that the use is not domestic. The circumstances would need to demonstrate that the accommodation in which the taxpayer works has been converted to business premises. That conversion will be evident where rooms in a home are used as a doctor's surgery and waiting room, or as a studio by an artist engaged in a business of painting, or as a workshop by a person engaged in a trade. The conversion will be evident where a person engaged in a profession or trade regularly receives and confers with, or supplies goods to, clients and customers. There will of course be problems of apportionment, more especially where the activity that gives the home a character as business premises is not all conducted in a distinct part of the home, but they are not the only problems of apportionment that are posed by s. 51(1).

8.33 Any attempt to characterise the expenses of the home study without reference to use must attract the criticisms offered by Stephen J. in *Handley*, and there is no escape from them. There is no reply to the criticism that the operation of s. 51(1) should not depend on the “vagaries of architecture” ((1981) 148 C.L.R. 182 at 188). Architecture is significant only to the extent that the objective inference of use of the home study as business premises may be assisted by it. The fact that a room is physically separate from other rooms which are used only for domestic purposes will assist an objective inference that the use of that room was for the purpose of income derivation, though it will not in itself be enough. But the fact that the room is physically part of a home, should not preclude
deductibility if an objective inference of use as business premises can be drawn.

8.34 Conceivably a barrister who rents a flat convenient to his chambers but does not sleep there, using the flat only as a study, may be entitled to deductions. This, one would think, is the marginal case—not that in Forsyth or Handley. The objective inference of use as business premises arising from the physical separation of the flat from his home is not compelling, and stands to be overcome by any use which is unequivocally domestic.

8.35 An inference of use as business premises should not be drawn from the occasional contact with others in business affairs that a taxpayer may make in his home. One might doubt that there was enough to justify a conclusion that the premises were business premises in Swinford (1984) 84 A.T.C. 4803. The case is, however, most helpful in offering a distinction between a home that is “business premises”, a phrase adopted in the formulation of principle above, and a home used for “business purposes”. The first phrase will describe a situation where overheads may be deductible. The second may describe a situation where costs of travel between home and another place of work are deductible. They will be deductible if the use for business purposes will make the home a place of business. The notion of place of business and its significance will appear from the further reference to Swinford in [8.70] below.

8.36 In Handley the Commissioner had allowed a deduction of an amount in respect of heating and cleaning of the home study, relying presumably on the decision in Faichney (1972) 129 C.L.R. 38 in which Mason J. allowed an amount in respect of lighting and heating. Handley affirms Faichney on the matter of deductibility of interest, rent, rates and insurance relating to a home study, but not on the matter of deductibility of heating and cleaning. The latter were not the subject of an appeal. There are however observations by Mason and Murphy JJ. in Handley which suggest that they might have held the heating and cleaning costs were not deductible. The reasons for allowing the lighting and heating costs in Faichney, while denying what might be called the overheads are less than compelling. In Handley Mason J. was content to explain his earlier decision by saying:

“There is no occasion for me here to re-examine that part of the decision in Faichney that resulted in the allowance of expenditure incurred by the taxpayer for light and heating while he was working in his study at home. At the time it seemed to me that a distinction, albeit a fine one, could justifiably be made between expenditure incurred in connection with the acquisition of the study as part of the home and expenditure not so incurred, but necessarily incurred in the course of
engaging in revenue earning activities which the taxpayer undertook in his study. As I say, that question does not presently arise” ((1981) 148 C.L.R. 182 at 195–196).

If one takes an approach in terms of use as business premises to the question of deductibility of overheads, the same approach should be taken to the deductibility of lighting, heating and cleaning.

8.37 The intention of preceding paragraphs is to adopt the view that an approach in terms of use as business premises should be taken to the question of deductibility of overheads. To this extent the view of this Volume agrees with the dissenting judges in Forsyth and Handley. But the view disagrees with the conclusions of the dissenting judges. There was no basis in either Forsyth or Handley for an objective inference of use as business premises.

Self-Education Expenses

8.38 The judgments in the Full High Court in Finn (1961) 106 C.L.R. 60 gave rise to a number of expectations about the deductibility of expenses incurred by a taxpayer for his own education: (i) One of these was that there should be no discrimination in principle between an employed taxpayer and a self-employed taxpayer. In Finn, Dixon C.J. said (at 64):

“For it is indeed important that officers and employees engaged at a salary in the exercise of a skilled profession should not be in a worse position in respect of the costs of better equipping or qualifying themselves in point of knowledge and skill than are those exercising the same profession as a calling remunerated in fees paid by clients or by the members of the public who, under whatever style, enlist their services.”

The observations were made in relation to persons engaged in the exercise of a skilled profession, but the case was concerned with such a person and the judgment does not indicate any readiness to contemplate discrimination between the employed and the self-employed in contexts other than the exercise of a skilled profession. Observations to the same effect by Windeyer J. in the same case are not limited to a taxpayer in a skilled profession. Windeyer J. said (at 70):

“Generally speaking, it seems to me, a taxpayer who gains income by the exercise of his skill in some profession or calling and who incurs expenses in maintaining or increasing his learning, knowledge, experience and ability in that profession or calling necessarily incurs those expenses in carrying on his profession or calling. Whether he be paid fees by different persons seeking his skilled services from time to time, or be paid a regular salary by one person employing him to exercise his skill, matters not in my opinion.”

Relevance—sufficiency of connection—is the same concept whether it be applied to an employee or to a self-employed person. There may of course be differences in result from the application of the same concept, because the income to which the
expense must be relevant is the taxpayer's income. In the case of an employee the expense must be relevant to his salary income, not the business income of his employer, though relevance to the latter must suggest relevance to the former. Where an employer meets directly the education expenses of an employee the discourse moves beyond the field of self-education expenses, though the concept of relevance remains constant. Some comment on deductibility by the employer and possible income quality of a benefit to the employee where education expenses of an employee are met by his employer, are the subject of comment in [8.53]ff. below.

**8.39 (ii)** Another expectation was that a self-education expense that is relevant, whether it be an expense of an employed or of a self-employed person, will always be a working expense. An expense of acquiring education for oneself might be described as an expense of acquiring “human capital”. However significant is the increase in knowledge or skill that results, it will not, it seems, be held to be a non-working expense. Dixon C.J. observed in *Finn* (at 69):

“You cannot treat an improvement of knowledge in a professional man as the equivalent of the extension of plant in a factory. Unfortunately, skill and knowledge of most arts and sciences are not permanent possessions: they fade and become useless unless the art or the science is constantly pursued or, to change the metaphor, nourished and revived. They do not endure like bricks and mortar.”

The observation would cover an expense in improving his own knowledge incurred by an employed or self-employed person.

**8.40 (iii)** A third expectation arising from *Finn* was that an expense of self-education may be deductible by an employed person, notwithstanding that the taxpayer is not required by the terms of his employment to incur the expense, and notwithstanding that his incurring of the expense does not generate a likelihood of an increase in his income by way of higher pay. It is true that Dixon C.J. in *Finn* gave significance to the fact that the education obtained by the taxpayer might “in respect of promotion to a higher grade, . . . prove decisive”, and to the fact that the taxpayer “was complying with the desires, and so far as going to South America was concerned, with the actual request of [his employer]” (at 67–8). It may be noted, however, that the taxpayer was not required by his employer to undertake the architectural studies, and that neither of the facts referred to by Dixon C.J. was stated to be essential. They were simply some of a number of elements which “considered in conjunction . . . [formed] a firm foundation for the conclusion that the expenditure was in truth incurred in gaining or producing assessable income” (at 68). Other facts were the taxpayer's motive to secure an advancement in grade and salary, and the view of his employer that the architectural studies were “a matter of distinct advantage to the [taxpayer's] work for the State” (at 67).

**8.41** The second expectation arising from *Finn*—that a self-education
expense will not be held to be a non-working or capital expense—has been maintained in the later single judge decision of Menzies J. in the High Court in Hatchett (1971) 125 C.L.R. 494 and the Supreme Court decisions in White (1975) 75 A.T.C. 4018 and Smith (1978) 78 A.T.C. 4157. But the first expectation—that there should be no discrimination—does not seem to have been sustained. It has come close to being abandoned in the abandonment of the third expectation. Tests have been developed such that an employed taxpayer is not entitled to a deduction for self-education expenses unless he is required by the terms of his employment to undertake the education, or there is a near-certainty that the successful completion of the programme of education will bring him a promotion and higher pay. These tests have been drawn from the decision of Menzies J. in Hatchett, though the tests have lost some of their authority as a result of the decision in Wilkinson (1983) 83 A.T.C. 4295 which suggests, in regard to the second test, that the “near certainty” of promotion and higher pay is too stern a test and something less may be enough to justify deduction. And the first test has lost some of its authority as a result of the refusal by the Federal Court in Martin (1984) 84 A.T.C. 4513 to accept that the first test will dictate a conclusion of relevance if an employee is required to incur expenses by his contract of employment. There are no similar limitations on deductibility applicable to a self-employed person. Relevance of self-education expenses in the case of a self-employed person will depend on a sufficient connection established by showing a purpose to maintain and advance his capacity to earn income, presumably in a business he presently carries on.

8.42 There are, no doubt, good reasons in policy why the relevance of self-education expenses should not be too readily accepted. Self-education may involve travel, which for many is a form of recreation. A too-ready acceptance of the relevance of self-education expenses opens a prospect of deductions being allowed which will operate to subsidise recreational expenditure. But the Revenue can be protected by insisting that the circumstances must yield a clear objective inference that the purpose of the expenditure was to maintain and further income earning capacity in relation to some current income-earning activity.

8.43 The specific tests of relevance in relation to an employee which have been developed out of the judgment of Menzies J. in Hatchett (1971) 125 C.L.R. 494, purporting to apply Finn (1961) 106 C.L.R. 60, are that the taxpayer must have been required by the terms of his employment to incur the expenditure, or must be able to show a near certainty of promotion if he is successful in the programme of education. The tests involve a discrimination against the employee. He may be denied deduction
notwithstanding that there is a clear objective inference to be drawn from the circumstances that the purpose of the expenditure was to maintain and further his capacity to earn income in his employment. In *White*, the judgment of Menzies J. in *Hatchett* was applied by Helsham J. to deny a deduction notwithstanding that such an objective inference was clearly to be drawn. The only mitigation of the rigor of the judgment of Menzies J. was a concession by Helsham J. that the taxpayer's failure or prospect of failure in the course of education he has undertaken will not necessarily require a denial of deduction. In *Smith* (1978) 78 A.T.C. 4157 and *Lacelles-Smith* (1978) 78 A.T.C. 4162 Waddell J. applied the judgment of Menzies J. in *Hatchett* with rather less concern for the second of the tests of relevance.

8.44 There is some suggestion in the judgment of Menzies J. in *Hatchett* that a discrimination in principle between the self-employed and the employed taxpayer is required by s. 51(1). The suggestion is that the employee cannot call on the second limb of s. 51(1), because that limb is confined to a taxpayer who carries on a business. Menzies J. threw doubt on the statement of principle by Windeyer J. in *Finn* quoted in [8.38] above by drawing attention to the fact that the language used by Windeyer J. was the language of the second limb. The point has already been made ([5.30]-[5.33] above) that there is little, if anything, in the authorities to indicate that the second limb has a concept of relevance which differs from the first limb. In any event, there is nothing in the authorities apart from the judgment of Menzies J. that acknowledges a difference in principle that would warrant the tests of relevance that Menzies J. has applied to an employee.

8.45 A test of relevance that would require the taxpayer to establish that it was a term of his contract of employment that he would pursue the education is not expressly adopted by Menzies J. in *Hatchett*. Attributing such a test to him is rather a matter of inference from his insistence that the employer's action to encourage the taxpayer to pursue the education was not enough. In fact in *Hatchett* the employer had made a contribution towards the fees the taxpayer had paid. A test that insists on a term of the contract of employment has been reasserted by Boards of Review relying on *Hatchett*, and relying on the interpretation of *Hatchett* in the judgment of Helsham J. in *White* (1975) 75 A.T.C. 4018. Helsham J. said (at 4022): “As the result of the decision in [Finn and Hatchett] . . . expenses incurred in pursuing studies associated with employment will qualify as allowable deductions under s. 51 when it can be said that those studies are part and parcel of the employment, which means that the expenditure is incurred in the process of carrying out the employee's duties, or, even if they are not
such, they can be seen to have a direct effect on income.” The test is expressed in the Boards of Review as requiring that pursuing the education must be a “condition” of the taxpayers' employment. The word “condition” appears in the judgment of Menzies J. in 

8.46 A test of relevance which makes the terms of the contract of employment critical may be narrower or broader in its operation than a principle which simply leaves relevance to be determined by an objective inference as to the purpose of the taxpayer in pursuing the education. It will be narrower in its operation, as it was in White (1975) 75 A.T.C. 4018, where the employer has done no more than encourage the employee to pursue the education, though the education has such direct significance in maintaining or increasing the taxpayer's competence to perform his work as an employee that an objective inference of a purpose of maintaining or increasing that competence must be drawn. It will be wider where the taxpayer is required to pursue the education by a term that may have been included in his contract at his request, though the education has only a remote significance in increasing or maintaining competence.

8.47 A test of relevance which requires an employee taxpayer to show a near-certainty of promotion and thus higher pay, comes near to adopting a “blast from the whistle” approach to relevance ([5.34] above), an approach rejected by the High Court in Charles Moore & Co. (W.A.) Pty Ltd (1956) 95 C.L.R. 344 and W. Nevill & Co. Ltd (1937) 56 C.L.R. 290. And it is a test that cannot be available to a taxpayer who has reached a level of employment from which no promotion is possible. He may be a managing-director, a senior academic or a judge. Such a taxpayer will be restricted to the test in terms of contractual obligation, and he may need to rely on the indulgence of the Commissioner in agreeing that it is an implied term of his employment that he will pursue education, notwithstanding that he enjoys a wide freedom of action in this matter.

8.48 It may that where the taxpayer is engaged in a “skilled profession” as he was in Finn (1961) 106 C.L.R. 60, the authority of Finn, without the
interpretation in Hatchett, can be claimed. The judgments in Finn do not insist that the taxpayer, who was not under any contractual obligation, would have been denied deduction had it not been for the prospect of promotion. In drawing attention to facts in Finn all judges were concerned with their significance as facts from which an inference of purpose to maintain and advance capacity could be drawn. There was no intention to select facts as being essential to deductibility. A distinct law for taxpayers in skilled professions is not warranted. Discrimination in favour of the employee who is in a skilled profession is as unacceptable as discrimination in favour of the self-employed.

8.49 A return to basic principles of deductibility expressed in relation to an employee in Finn, should not open the floodgates which the Commissioner, judges and board members may fear. The undertaking of education directed to a general improvement in knowledge does not justify an objective inference of purpose to maintain and increase competence in an employment, whatever the nature of that employment. And education directed to the gaining of knowledge in a specific discipline other than that in which an employee is involved in his current employment does not yield any objective inference. The expense of gaining knowledge in a specific discipline may be connected with an activity in earning income which the taxpayer has planned to enter, but it is unlikely to be judged sufficiently connected. In any event, it will be denied deduction because of the contemporaneity principle if that principle is maintained. Where education is sought by observation in the field and discussions with persons who work within the same discipline as the taxpayer, a taxpayer whose employment requires him to expand knowledge, not just his own knowledge, may be better placed. There will always be marginal situations where a decision cannot be manifestly correct. But a decision that rests on the application of principle, rather than on tests that may operate in defiance of principle, even though the decision on the basis of the latter may be the more predictable, is to be preferred.

8.50 The contemporaneity principle seems to have been ignored by Lee J. in Highfield (1982) 82 A.T.C. 4463. The taxpayer who incurred expenses in respect of advanced dental studies overseas had leased his dental practice to another. At the same time Lee J. raised the possibility that expenses of advanced studies that may qualify the taxpayer for entry into a specialist practice may be seen as non-working. The expectation arising from Finn that a relevant expense will always be seen as working may, to this extent, be qualified. Finn would reject any view that expenses of self-education are capital as expenses of acquiring “human capital”. But the case does not preclude an argument that an expense that may be seen as
incurred for the purpose of obtaining a right to engage in an arm of professional activity presently denied to the taxpayer, is a non-working expense.

8.51 Generally, an expense of self-education will be deductible as to the whole of it, or not at all. In this, as in other contexts, doubts about relevance are not to be expressed by allowing a deduction of only part of the outgoing ([9.11] below). Clearly a conference fee, so far as it relates to attendance at conference sessions and to the obtaining of conference papers, must be deductible as to the whole of it or not at all. Deductibility of accommodation and food expenses while attending the conference will follow the deductibility of the conference fee. Deductibility of expenses for fares in attending the conference will follow the conference fee if the expenses for fares have no other function than enabling the taxpayer to attend. If attendance at the conference is preceded or followed by a substantial holiday in the area where the conference is held, or at some stopover en route to that area, deductibility of fares, otherwise accepted as relevant, may become doubtful. The existence of purposes of the expense other than self-education may justify a conclusion that there is insufficient connection of the expense with income derivation to make it relevant. An apportionment is not appropriate. There may be a deduction of such part of the fares expense as relates to the cost of travel beyond the stopover. But where a holiday is taken in the area of the conference a deduction of part of the fares could be seen as an attempt to express a doubt about relevance through an apportionment. The approach to apportionment of an expense suggested in [9.11] below is that it is proper only when a separate outgoing could have been made to serve the purpose that would give the expense relevance.

8.52 Section 159U provides for inclusion of the “expenses of self-education” in concessional rebate expenditure that may attract a rebate of tax under s. 159N. The amount that may thus be treated as a rebatable amount is limited by s. 159U(3) to $250. The definition in s. 159U(5) of “expenses of self-education” limits those expenses so that they must relate to “a course of education provided by a school, college, university or other place of education and undertaken by the taxpayer for the purpose of gaining qualification for use in the carrying on of a profession, business or trade or in the course of employment”. It will be apparent that the expenses so defined will cover some expenses that would not be deductible under s. 51(1). To this extent s. 159U expands tax relief. But clearly the definition could cover expenses that would be deductible under s. 51(1). Overlap and possible relief by deduction as well as by rebate is however precluded by provisions in the definition and in s. 82A. Expenses that would be
deductible under s. 51(1) that are otherwise within the definition of expenses of self-education are, to the extent of the first $250, denied deduction under s. 51(1), and must be dealt with as rebatable amounts. Whether they will thus generate any actual rebate of tax depends on there being a total of rebatable amounts exceeding $2,000 (s. 159N).

8.53 An employer may meet directly the costs of education undertaken by an employee. The employer may, for example, pay directly the fares and conference fees of an employee attending an overseas conference. The costs will be deductible by the employer, whether his purpose in meeting them was to secure an increase in the competence of his employee or to confer a benefit on the employee by way of a reward for his services. If the employer's purpose is to bring about an increase in the competence of the employee, it is arguable that any benefit to the employee is one inherent in the conditions of his employment—a concept examined in [4.43]–[4.44] above and it is not a benefit which is income under s. 26(e). An analysis which may be indistinguishable from the condition of employment analysis would be that the payment by the employer is not income of the employee as it is a contribution to capital within Proposition 7. *Hochstrasser v. Mayes* [1960] A.C. 376 is relevant. In these circumstances there may be an advantage in the direct payment by the employer. If the employee incurs the expense himself, he may be denied a deduction, even though he has incurred the expense in the interest of the employer. There is no necessary correlation between the operation of the condition of employment or contribution to capital principle and the deductibility of the expense if incurred by the employee. It was suggested in [4.56] above that the provision by the employer of residential accommodation to an employee called on to live in a remote place may not be a benefit to the employee that is his income. It is a contribution to capital. Yet the employee may be denied deduction of the expense of that accommodation if he incurs it himself.

8.54 Where the employer's purpose is to confer a benefit on the employee by way of a reward for his services, there is a prospect that the benefit is not a condition of employment or a contribution to capital, but is an item of income of the employee under s. 26(e). There will be no expense incurred by the employee that could generate an off-setting deduction available to the employee. There will of course be no unfairness if an expense incurred by the employee for the education would not have been deductible in any event. There is, however, a prospect of unfairness if there is a benefit that is an item of income of the employee, and the cost of that benefit, if it had been met by the employee himself, would have been deductible by him. At least in theory a situation of this kind is possible. The view taken of the
expense incurred by the employer—whether it is an expense to increase the
competence of the employee in carrying out his work for the employer or is
an expense in rewarding the employee—does not provide an answer to the
question whether the expense, if incurred by the employee, would have
been deductible by him.

8.55 There may in some circumstances be a question of who has incurred
the education expense. An employee may meet the expense with cash or a
credit card facility, provided by his employer. In such circumstances the
employer has incurred the expense, and the issues are whether the
employer can deduct and whether the employee has a benefit that is his
income. An employee may meet the expenses from his own resources,
under an agreement with his employer that he will be reimbursed. Two
analyses of the circumstances are possible. One analysis would treat the
employer as having incurred the expense, with the consequences already
described. The other analysis would treat the employee as having incurred
the expense, which may be deductible as an expense related to the
employee's income. In this case the reimbursement will be income of the
employee if the employee's expense is deductible by him. Alternatively,
the reimbursement will be treated as not being income of the employee to
the extent that it reimburses what would otherwise be an allowable
deduction available to the employee, and deduction will be denied to the
employee on the ground that no outgoing has been incurred by him. If the
employee is not entitled to a deduction, the reimbursement may none the
less be his income. It will not be his income if it can be seen as a
contribution to capital. Though not deductible, the expenses the employee
has incurred may yet be seen as incurred in the interests of the employer. It
will be apparent that the net consequences for the employee may be
different depending on the analysis that is followed.

8.56 The discussion of the deductibility of self-education expenses has so
far been confined to expenses that relate to business or employment
income. In theory, at least, an expense of education may be relevant to
passive income—income derived from property that is not business
income. The issue will be whether the purpose of the expense, objectively
determined, is to maintain and further the taxpayer's competence to invest.
There is no judicial decision in which the deductibility of self-education
expenses claimed to be relevant to the derivation of passive income has
been considered.

Expenses of Travel

8.57 The deductibility of expenses of travel that are expenses of self-
education, or the education of an employee, has been considered in [8.38]–[8.56] above. The deductibility of travel expenses depends on their relevance, working character and contemporaneity. In the case of deduction by an employee, tests expressing the principle of relevance will emphasise the obligations of his employment. And relevant travel expenses, whether of a self-employed or an employed person, may be denied deduction as non-working. The possibility of a relevant travel expense of an employee being treated as non-working may be remote. The character of the expense must be judged with reference to the income of the employee, not that of his employer. A relevant travel expense of a self-employed person may well be non-working. Travel expenses associated with a study of the feasibility of establishing a business will be non-working. Travel in seeking to obtain a contract which will be a structural asset of a contemplated or subsisting business will be non-working.

8.58 Travel expenses must be judged for deductibility by the principle of contemporaneity. The expenses of travel in seeking to obtain a contract that will be an asset of a contemplated business may come too soon. If the contract is not obtained and no business operations are ever entered upon, it is arguable that no business had commenced at the time the travel expenses were incurred. The question whether action taken to establish a business involves the commencement of a business was raised by Southern Estates Pty Ltd (1967) 117 C.L.R. 481 and was considered in [2.442] above. The deductibility of travel expenses in seeking to obtain a contract to provide services, which may be an employment contract, were the subject of comment in [5.46]–[5.47] above.

8.59 Where an employee's travel expenses are met directly by his employer, the questions of deductibility by the employer, and the derivation of a benefit that is income of the employee, call for the analysis already attempted in relation to education expenses of an employee met by his employer. The expense may be deductible by the employer (i) as an expense of the employer's business activity, the expense not being directed to rewarding the employee for his services, or (ii) as an expense directed to giving such a reward. In instance (i), any benefit to the employee is unlikely to be his income—it is a condition of his service. In instance (ii) any benefit to the employee will very likely be his income under s. 26(e). There is again the prospect that the benefit will be his income, though he has no deduction, because he has not incurred any expense.

8.60 Some of the most debated questions of relevance arise in relation to expenses of travel which involve, wholly or in part, the movement of a self-employed or employed person between his home and a place of work.

8.61 Lunney (1958) 100 C.L.R. 478 is taken to have settled the question as
it arises in the simple case where there is a sole place of work at a distance from the taxpayer's home or, expressed in the frame of reference of the reasoning in the judgments in the case, where the taxpayer has a home at a distance from a sole place of work. The expenses of travel, it is said, are incurred in order to enable the taxpayer to live away from his work. The reasoning is adopted from the Court of Appeal judgment in Newsom v. Robertson [1953] 1 Ch. 7. Dixon C.J. in Lunney adopted the reasoning with some reluctance, and McTiernan J. dissented. The other members of the court accepted the reasoning without expressing any reservation. Newsom v. Robertson was decided on United Kingdom legislation which requires that the expense be incurred wholly and exclusively for purposes of the trade, profession or occupation. Denning L.J. said (at 16):

“A distinction must be drawn between living expenses and business expenses. In order to decide into which category to put the cost of travelling, you must look to see what is the base from which the trade, profession, or occupation is carried on. In the case of a tradesman, the base of his trading operation is his shop. In the case of a barrister, it is his chambers. Once he gets to his chambers, the cost of travelling to the various courts is incurred wholly and exclusively for the purposes of his profession. But it is different with the cost of travelling from his home to his chambers and back. That is incurred because he lives at a distance from his base. It is incurred for the purposes of his living there and not for the purposes of his profession, or at any rate not wholly or exclusively; and this is so, whether he has a choice in the matter or not. It is a living expense as distinct from a business expense.”

An Australian court could have decided that the existence of some purpose that was not a purpose of earning income did not preclude deduction of the travel expenses. Lunney is a decision that the element of purpose to enable the taxpayer to live away from his place of work was of such significance that the expenses were insufficiently connected with the derivation of income. The decision has hardened to a point where it is not open to re-examination for its validity as an expression of the principle of relevance.

8.62 There is a passage in the judgment of Williams, Kitto and Taylor JJ. in Lunney which calls for some comment:

“It is, of course, beyond question that unless an employee attends at his place of employment he will not derive assessable income and, in one sense, he makes the journey to his place of employment in order that he may earn his income. But to say that expenditure on fares is a prerequisite to the earning of a taxpayer's income is not to say that such expenditure is incurred in or in the course of gaining or producing his income. Whether or not it should be so characterised depends upon considerations which are concerned more with the essential character of the expenditure itself than with the fact that unless it is incurred an employee or a person pursuing a professional practice will not even begin to engage in those activities from which their respective incomes are derived” ((1958) 100 C.L.R. 478 at 498-9).
The passage is the basis of the reasoning of Mason J. in Lodge (1972) 128 C.L.R. 171 referred to in [8.25]–[8.27] above. Child minding expenses may be an “essential prerequisite” to the derivation of income. But their character was “nursery fees for the appellant's child” and as such they were not relevant to the derivation of income. The analysis is not easily unravelled in either case. It appears that the determination of “essential character” makes possible a conclusion on relevance. The determination of essential character involves the adoption of a description of the expense which affords an answer to the question of relevance. The description in effect asserts the relevance or want of relevance of the expense. The analysis tends rather to cloak than to reveal the process of decision. No analysis can deny the evaluation that must be made in concluding that an expense is relevant or irrelevant.

8.63 The analysis appears to undergo some change as it is adopted in the judgment of Mason J. in Handley (1981) 148 C.L.R. 182 at 194:

“Expenditure related to the study is therefore referable to the home. The ‘essential character of the expenditure’ to take up the expression used in Lunney (1958) 100 C.L.R. 478 at 497 is therefore that of a ‘capital, private, or domestic nature’.”

The determination of “essential character”, on the face of this analysis, goes not to the determination of relevance but to the question whether an expense that may be relevant is to be denied deduction because of the private or domestic exception.

8.64 Lunney and the contemporaneous decision in Hayley (1958) 100 C.L.R. 478 settle, for a self-employed or an employed person, that expenses which are no more than the costs of the taxpayer's movement between a sole place of work and his home are not sufficiently connected with income derivation to be relevant. The cases are applied in Burton (1979) 79 A.T.C. 4318. But they do not answer the question of relevance in circumstances where:

(a) where the expenses have another purpose than providing for the taxpayer's movement between work and home;
(b) where the movement is a movement between two or more places of work;
(c) where the movement is between shifting places of work and the taxpayer's home;
(d) where the movement is between a place of education and the taxpayer's home; or
(e) where the movement is between a home adjacent to an old place of work and a home adjacent to a new place of work.

Each of these situations calls for some examination.

8.65 An illustration of situation (a) may be an expense of travel when the taxpayer transports equipment he uses at his place of work. The expense of travel may be an expense of safeguarding the equipment, and of using it in his business or employment at home. The cost of transporting a bulky musical instrument in the taxpayer's station wagon was so characterised by Waddell J. in Vogt (1975) 75 A.T.C. 4073: the taxpayer was employed to play music on the terms that he would provide his own instruments, and
would bring them to performances and rehearsals. Allowing the deduction of the expense of transporting the tools and equipment where the taxpayer is carried in the vehicle in which they are transported, will in effect allow the taxpayer a deduction of the cost of his own movement between his home and a place of work. His own movement is, however, a consequence of action to safeguard the equipment and to have it available for use at home. That movement is not the purpose of the expense.

8.66 An expense which relates to the movement of a taxpayer who is safeguarding equipment will not always be open to this characterisation. A taxpayer who carries files in a briefcase to safeguard them and to have them available to be worked on at home, will find it difficult to establish that the fare for the journey on which he carries the files was paid to safeguard the files and to have them available for work at home. None the less, Waddell J. in *Ballesty* (1977) 77 A.T.C. 4181 attributed some significance to the fact that the taxpayer carried his football clothes between home and places of training for and playing football. Waddell J. also gave significance to the taxpayer's claim that the expenses of using his own car were expenses of ensuring that he would be in the right frame of mind for training and playing and were thus relevant. An acceptance of that line of argument would, in effect, reject *Lunney*.

8.67 The argument that the taxpayer made, successfully, in *Vogt* has its parallel in the argument that the use by an employee of a motor car owned by his employer for travel to and from the employee's home is a use to safeguard the motor car, and that the benefit to the employee in being moved between work and home is a condition of his service and not a reward for his service.

8.68 Situation (b) is illustrated by *Sargent v. Barnes* [1978] 2 All E.R. 737. The taxpayer maintained a laboratory away from his dental surgery. A dental mechanic, who was not an employee, worked part time at the laboratory, and the taxpayer called there on his way to and from home to pick up dentures that had been made by the mechanic, and to deliver impressions from which dentures would be made. Oliver J. rejected the argument that the cost of that part of the taxpayer's travel that was between surgery and the laboratory was deductible. The whole of the expenses of travel between surgery and home remained expenses in order to enable the taxpayer to live away from his work, notwithstanding that he called at the laboratory. Oliver J. professed to look at the matter “realistically”, and concluded that what the taxpayer was doing “was calling to deliver and pick up work on his way to and from the surgery where the practice was carried on”. The case is a recognition that no firm rule can be stated that travel between two fixed places of work is deductible. The taxpayer must
on the occasion of movement between the two places be said to carry on work at each place. If there is work carried on at each place on the occasion, deductibility will follow, at least where each place of work is within the same business or employment. Picking up and delivering were not acts of carrying on work at the laboratory. An alternative argument the taxpayer might have made would be that the expenses of travel between laboratory and surgery were expenses of delivering dentures and impressions. The observations made in [8.65]–[8.66] above in regard to Vogt and Ballesty are relevant.

8.69 Travel expenses between two places of work may be deductible notwithstanding that one of the places of work is the taxpayer's home. There is a question of the extent and nature of the activity that will amount to the carrying on of work at a place of work. The question is, however, distinct from the question whether the activity when carried on at home would make the expenses considered in the “home study” cases deductible. Where the issue is deductibility of travel expenses, the activity must be carried on at the time of the movement. Where the issue is deductibility of the expenses of the shelter afforded by the home, deductibility depends on the character of the use made of the home during the year of income. And travel expenses may be deductible notwithstanding that the expenses of the shelter are not. Telephone instructions from home to a hospital about the treatment of a patient given by a doctor on call to give such instructions were held to be enough in Owen v. Pook [1970] A.C. 244 to make the taxpayer's home a place of work, so as to allow a deduction of expenses of travel to the hospital to perform surgery on the patient. It would however be assumed that the giving of such instructions from home does not justify a deduction of some of the expenses of the home as a place of shelter. The insistence in the dissenting judgment of Stephen J. in Handley 148 C.L.R. 182 at 192-3 that Lunney (1958) 100 C.L.R. 478 and Newsom v. Robertson [1953] 1 Ch. 7, and the idea of a “base of operations” at home, cannot be applied to the quite different case of deductibility of home office expenses, is to be preferred to the suggestion in the judgment of Wilson J. in Forsyth (1981) 148 C.L.R. 203 at 215 that they can.

8.70 In Swinford (1984) 84 A.T.C. 4803 Hunt J. drew a distinction between a concept of a place of work which will justify deduction of shelter expenses, and a place of work which may justify deduction of travel expenses between the place of work and some other place of work. The taxpayer was a script writer who claimed a part of the rent of her flat attributable to a room she used as a home office. She worked at other places only when she attended rehearsals of scripts she had written, or delivered scripts she had written, or picked up instructions for scripts to be
Hunt J. said (at 4806):

“The area designated as a ['home office'], it seems to me, may either constitute business premises notwithstanding the physical association of that area with the taxpayer's home, or it may be only part of the taxpayer's home (such as a study) used for business purposes as a matter of convenience.”

The words “business premises” to identify a home office which will justify deduction of shelter expenses and a “part of (a) home . . . used for business purposes” to identify a home office that may justify a deduction of travel expenses is helpful, though the words “as a matter of convenience” added to the latter words tend to obscure the analytical distinctions that need to be drawn between (i) business premises, (ii) a place of business and (iii) a home where business work is done. Business premises are premises in a home in which work is done that is beyond any notion of domestic use of premises. The notion of domestic use may include business work—a phrase used in the present context to include employment work. Some business work, even if it be only searching for solutions to business problems, is done at home by almost every person. If work is done that is beyond any notion of domestic use of premises, shelter expenses will be deductible to the extent that they are fairly attributable to the area of the home used, and the time devoted to that work.

8.71 A place of business will identify a place in a home where business work is done that cannot be described as work done in that place simply as a matter of convenience. The taxpayer in Owen v. Pook ([8.69] above) might be said to have had a place of business at home. Business premises will be a place of business only while business is done in the business premises. If a taxpayer has a place of business at home he will be entitled to a deduction of travel expenses from his home to another place of business outside his home, if the travel follows immediately on the doing of the business work at home, and the expenses are otherwise deductible as expenses of travel between two places of work.

8.72 A home where business work is done will identify a home where work is done that is not of a kind that may make a home business premises or a place of business. A home where business work is done will not justify a deduction of shelter expenses nor will it justify a deduction of travel expenses. The work is such that it is no more than work conveniently done at home, or work described as work “taken home” in Newsom v. Robertson. Work that will make home a place of business might by one test be identified as work that “needs” to be done at home, because some part of the home has been adapted to the doing of that work. The adapting will have converted part of the home to business premises. Work in a doctor's surgery at home is the obvious illustration. Another test may be that there is no other place where the work can conveniently be done, which would explain Horton v. Young [1972] Ch. 157 referred to in [8.75] below and would make the place of work in Swinford a place of business.
8.73 In *Owen v. Pook* [1970] A.C. 224 deduction was claimed and allowed of expenses of travel between home and hospital incurred on those occasions when telephone instructions had been given by the taxpayer. The taxpayer might be said to have had a place of business at home. Lord Donovan, who dissented and would have denied the deduction of the travel expenses, confused the concept of place of work for purposes of travel expenses—a place of business—which calls for a judgment on activity at the time of the travel, and what may be the concept of place of work—business premises—for purposes of deductibility of home shelter expenses, which calls for a judgment on activity over the year of income. Lord Donovan said (at 261):

“There are also thousands of employees in other walks of life who have to be on stand-by duty at their homes and are required to obey a summons to go to their factory or their offices to cope with some emergency. If this is to mean that they will have two places of employment I see no reason why all of them should not be entitled to claim travelling expenses between their homes and their places of work.”

The consequence of the decision in *Owen v. Pook* in the circumstances envisaged by Lord Donovan would be deductibility of expenses of travel only on those occasions when the employee is in fact summoned to go to the factory to cope with some emergency, and he gives telephone instructions as to what should be done before leaving home.

8.74 It is true that in *Newsom v. Robertson* [1953] 1 Ch. 7 the issue of deductibility of expenses of travel between home and a place of work is put in terms of the home being a “base” of “operations”. The language may help to emphasise that there is a question of the extent and nature of activity at home that will be sufficient to make home a place of business for purposes of a rule allowing deduction of travel expenses. *Newsom v. Robertson* is authority that working on matters “taken home” is not enough to justify a deduction for travel expenses on the occasion when work is taken home. No authority would be necessary to deny a deduction of travel expenses on those occasions when work is not taken home. The fact that home may on some occasions be a place of business does not make it a place of business on those occasions when no work is in fact carried on at home.

8.75 The view of activity at home that will be sufficient to make it a place of business taken by Waddell J. in *Ballesty* (1977) 77 A.T.C. 4181, would virtually reject *Lunney* (1958) 100 C.L.R. 478. The taxpayer was a professional footballer who claimed the expenses of travel between home and places where he trained for matches, or played in matches. Waddell J. said (at 4185): “I think that on the whole the taxpayer should be regarded as having embarked upon the activities by which he earned the assessable
income when he left his home to travel either to a match or to training and as continuing in those activities on his journey home. In this sense his place of residence should be regarded as his base of operations.” The intention would appear to be to bring the circumstances within Owen v. Pook. But the rule in Owen v. Pook [1970] A.C. 244 is clearly not wide enough to extend to the facts in Ballesty. Waddell J. referred to Horton v. Young [1972] Ch. 157. In that case, the Court of Appeal found that the taxpayer engaged in activities at home sufficient to make it a place of business. It was “the locus in quo” of his trade, the “business base” or “centre of activities”. The taxpayer was a self-employed bricklayer who employed a team of other bricklayers and contracted to carry out building work. He would conclude contracts at home, in writing or by telephone, and would instruct members of his team. A conclusion that the taxpayer had a place of business at home was open on the facts in Horton v. Young, but was not open in Ballesty.

8.76 It is true that there are observations in the judgment of the Court of Appeal in Horton v. Young which suggest that a taxpayer will always have a place of business at home if he works at shifting places away from home, as a building worker does. But the taxpayer who travels between home and shifting places of work does not need to show that his home is a place of business to establish the deductibility of his travel expenses. In Horton v. Young, Brightman J. at first instance, said (at 163–164):

“There are, however, some occupations in which the self-employed person does not have any location which can readily be described as his place of business, but, rather, a number of places at which from time to time he exercises his trade or profession. It seems to me that there is a fundamental difference between a self-employed person who travels from his home to his shop or office or his chambers or his consulting rooms in order to earn profits in the exercise of his trade or profession and a self-employed person who travels from his home to a number of different locations for the purely temporary purpose at each such place of there completing a job of work, at the conclusion of which he attends at a different location. I do not think it matters in the latter type of case whether the taxpayer does or does not effectively carry on any trade or professional activities in his own home. The point is that his trade or profession is by its very nature itinerant. When the chimney sweep leaves his home in the morning and goes from house to house with the aid of his car or van, it appears to me unrealistic to deny that he incurs all such travelling expenses wholly and exclusively for the purposes of his trade. There must be plenty of other self-employed persons whose jobs are similarly itinerant. The test cannot be whether the job keeps the taxpayer at a particular location for perhaps two hours, as in the case of the chimney sweep, or three weeks, as in the case of Mr Horton.”

Like observations may be made with equal force in regard to an employee with shifting places of work. The expenses in these circumstances are deductible because
the rule in Newsom v. Robertson and Lunney has no application. It is not a case of travel between places of work. It is a case of expenses which cannot be described as a consequence of the taxpayer's choosing to live away from his work. At least this is so when the taxpayer's work is itinerant within a certain area. Where his home is outside the area, Brightman J. left open the possibility of concluding that the expenses of travel should be denied deduction so far as they relate to travel to and from the border of the area.

8.77 The discussion so far has proceeded on the assumption that the expenses of travel between places of work relate to places of work within the same business or employment. It may be argued that travel between a place of business of one business or employment and a place of business of another business or employment is to be differently regarded. It would be agreed that the expenses of that travel are not undertaken to enable the taxpayer to live away from a place of work. If any judgment is made of that kind, it is that they are undertaken to enable the taxpayer to work in another business or employment and should be regarded as relevant to one of them, though to which one is not obvious. In Garrett (1982) 82 A.T.C. 4060 the taxpayer was in business as a farmer at his home, and as a medical practitioner in a number of towns including his home town. He travelled in his own aircraft between these places. The fact that he had a medical practice in his home town obscured the question of deductibility now considered.

8.78 Deductibility must, however, be dependent on actual work in each place of business on the occasion of travel. A taxpayer who has a place of business at home in relation to one business or employment and a place of business in relation to another business or employment elsewhere, will not be entitled to a deduction of the cost of travel on an occasion unless the travel follows immediately on the performing of work in his business at home, and there is work performed on arrival at the place of the other business. If he were held entitled to a deduction in all circumstances, Lunney would be rejected. The physical presence of the taxpayer at a place of business which is a consequence of the fact that he has a place of business at home, is not enough to justify deductibility of travel expenses between home and another place of business. The decision of Oliver J. in Sargent v. Barnes [1978] 2 All E.R. 737 has a bearing.

8.79 Situation (c) concerns expenses of travel where the movement is between the taxpayer's home and shifting places of work. The view was expressed above that such expenses are deductible, not because the home is in any sense a place of business, but because the reasoning in Lunney is inapplicable: it is appropriate to regard the expenses as a consequence of the location of the places of work. The footballer in Ballesty was entitled to deductions not for the reasons given in the judgment, but for the reasons
given by Brightman J. for allowing the deductions at first instance in *Horton v. Young*. The observation by Lusher J. in *Garrett* (1982) A.T.C. 4060 at 4063 that a commercial traveller is entitled to deduction for expenses of travel from home because he keeps samples at home is misleading. He is entitled to deductions of travel expenses because shifting places of work dictate that he travel. The relief schoolteacher who may be asked to teach at a different school each day is entitled to deductions. There is a possible qualification suggested by the judgment of Brightman J. in *Horton v. Young* [1972] Ch. 157 which would confine deductibility to travel which is within the borders of the area in which the shifting places of work are to be found. The words “to the extent to which” in s. 51 would be relied on in the application of the qualification. However the problems of identifying the area, more especially when the business operations of the taxpayer or his employer are international, will discourage the adoption of the qualification.

8.80 Situation (d) concerns expenses of travelling between a place of education and home. Assuming that the expenses of self-education are in a particular case deductible, there is a question of whether travel expenses are to be included in the deductible expenses. Such expenses were allowed in *Finn* (1961) 106 C.L.R. 60 without any reference to the fact that the travel was from home. As in the shifting places of work situation, the expenses are not undertaken in order to enable the taxpayer to live away from his work. It will follow that the travel expenses of a taxpayer who goes from his place of work to a place of education and thereafter to his home are deductible, if other expenses of the self-education are deductible.

8.81 Situation (e) concerns travel from a home adjacent to an old place of work to a home adjacent to a new place of work. The employee who meets his own travel expenses when he is asked by his employer to change his place of work from one city to another may claim the expenses of his own travel, notwithstanding that the travel begins and ends at a home. In the circumstances the travel should be seen as travel between two places of business. Expenses of moving his household effects and the travel expenses of members of his family raise different issues. They are not relevant. Which is not to say that the tax law will treat a reimbursement to the employee of such expenses as a derivation of income by the employee. The view was taken in [2.120]–[2.121] above that a reimbursement in these circumstances, or an allowance to meet the expenses, or a direct payment by the employer of the expenses, is not income: it is a contribution to capital.

8.82 Where the movement is made necessary by the fact that the taxpayer has accepted a new employment, neither his own travel expenses nor any
of the other expenses referred to that are associated with the move appear to be deductible. In the case of the taxpayer's own travel expenses relevance may be doubted. *Lunney* may be thought applicable. A reimbursement of all the expenses by the new employer may, however, be regarded as a contribution to capital, and thus not income, unless it is held that this would be to reject *Lunney*.

**Expenses of Entertainment**

8.83 The deductibility of expenses of entertainment raises a question of relevance to the derivation of income. Where the taxpayer is an employee, the expense must be relevant to the derivation of his employment income, not the income of his employer.

8.84 In this area, as in the area of self-education expenses, there are no doubt good reasons in policy, perhaps stronger reasons, why relevance should not be too readily accepted. Entertainment of others may well be recreation for the taxpayer who entertains, and a tax subsidy for expenses of recreation is not the intention of s. 51(1). In the United Kingdom there is a statutory prohibition on deduction of business entertainment expenses (s. 41 of the *Income and Corporation Taxes Act* 1970).

8.85 Relevance is again a matter of sufficient connection with the derivation of income, and the purpose of the taxpayer will be the focus of any judgment. How far purpose is a matter of objective inference, and how far subjective purpose has a bearing, are questions already considered. That there were mixed purposes, some of them not being purposes of securing the derivation of income, will not necessarily preclude deductibility. It might be argued that the expenses should be apportioned, so that they are denied deduction to the extent that they have a purpose other than the derivation of income, for example a purpose to enjoy conviviality. Apart from the administrative difficulty in applying apportionments in such circumstances, an apportionment will be used as a way of expressing a doubt about the relevance of an expense. A preferable view of the entertainment expense, the health expense referred to in [8.16] above and the travel expense referred to in [8.51] above, is that it must be the subject of a single judgment. Thus an entertainment expense that may be said to be predominantly to obtain the enjoyment of conviviality should be judged irrelevant as to the whole of its amount. An expense whose purpose is predominantly to further the functions that belong to an employee's office as an academic—*Sharma* (1984) 84 A.T.C. 4260—should be judged relevant as to the whole of its amount.

8.86 Deductibility of the self-employed's expenses of entertainment will
depend on the existence of a purpose to maintain and further goodwill of
the business, or to secure action from the person entertained in the interests
of the business. In the case of an employee's expenses, the like purposes
are not necessarily such as will ensure deductibility. Connection with the
employer's income does not of itself establish connection with the
employee's income.

8.87 There are two Australian judicial decisions on the deductibility of
entertainment expenses, both involving employees. They are Frankcom
the taxpayer—a magistrate—in the first case to establish deductibility, and
the success of the taxpayer—an academic—in the second, may indicate
that the notion of relevance in this area is subtle. In both cases the purpose
that might establish deductibility was the maintaining of good relations
with professional colleagues. In Frankcom deduction was denied of
expenses of entertaining visiting judges and magistrates and other lawyers.
In Sharma deduction was allowed of expenses of entertaining visiting
judges and academics, and local colleagues. Neither case insisted on a test
of relevance which might be thought to have been established by Hatchett
(1971) 125 C.L.R. 494, in relation to self-education expenses, which would
require that there be a term of the contract of employment, perhaps an
express term, that the employee should incur the expenses. In both cases
there is, however, a test that might be expressed in terms of the functions
of the office, and the differing outcomes may be explained on the basis that
maintaining good relations with colleagues does not further the carrying
out of the functions of the office of magistrate, at least not in the degree to
which it furthers the functions of an academic. In Sharma the taxpayer was
also successful in being allowed the deduction of expenses of entertaining
students. The entertaining of visitors, local colleagues and students was
seen as contributing to the acquisition and spreading of knowledge which
are the principal functions of an academic.

8.88 The ignoring of any test of relevance which might be described as a
term of the contract of employment test—foreshadowed in Wilkinson
(1983) A.T.C. 4295 in regard to self-education expenses, and in Martin
(1984) A.T.C. 4513 in regard to child care expenses—is a happy
development. A term of a contract of employment can always be arranged.
The cases are notable in another respect. There is no suggestion that the
expenses might have been denied in part so as to reflect the purpose of
enjoying conviviality which must have been present, at least in the Sharma
case. In the view of this Volume an apportionment ought not to be used as
a way of expressing a doubt about relevance.

8.89 An entertainment allowance paid by an employer to his employee will
generally be income of the employee. And a reimbursement of entertainment expenses incurred by the employee will generally be income of the employee. Deductibility of the expenses will depend on their relevance. If they are not deductible there may be room for a submission that the reimbursement, or indeed an allowance in respect of entertainment expenses, is not income because it is a contribution to capital, in the meaning of those words explained in [2.113]ff. above. The contribution to capital principle assumes that the expense in relation to which the contribution was made was an expense incurred in the interests of the employer—as in *Hochstrasser v. Mayes* [1960] A.C. 376— which is not necessarily a test of deductibility by the employee. The contribution to capital principle rests on the basis that there is no gain by the taxpayer when he receives an amount in respect of an expense that he incurs in furthering the interests of the person from whom he receives the amount.

**8.90** In [8.53]ff. above there is a discussion of the consequences that may flow when an employer meets directly the costs of education of his employee. There is a prospect that the education provided by direct payment by the employer involves a derivation of a benefit which is income of the employee, while the employee is denied a deduction of an expense because he has not incurred any expense. There is some prospect of the like kind in regard to entertainment expenses met directly by the employer. It may, however, seem unlikely that the employer's action in meeting the expenses would be regarded as conferring a benefit on the employee, as distinct from providing a condition of employment, in circumstances where the expenses if incurred by the employee would be deductible by him.
Chapter 9: Apportionment of Expenses

Section 51(1)—“to the Extent to which”

9.1 The phrase “to the extent to which” appears twice in s. 51(1). The significance of the second use of the phrase for the debate as to the function of the exceptions—whether they are merely stated by way of contradistinction or are true exceptions—was the subject of some comment in [5.9] above. The phrase was first included in the general deduction provision in the 1936 Act. At the same time a requirement that an outgoing to be deductible must be “wholly and exclusively” for the purpose of deriving assessable income was omitted from the Assessment Act. The changes were noted in *Ronpibon Tin N.L.* (1949) 78 C.L.R. 47 at 55:

“[Section 51(1)] is in great part made up of expressions taken from ss 23 (1)(a) and 25(b) of the *Income Tax Assessment Act* 1922–1934, expressions that have been elucidated by many decided cases. But there are very important differences between the operation which the present s. 51(1) is framed to produce and the manner in which the former s. 23(1)(a) and s. 25 worked. Some of these differences it is desirable to mention. In the first place the principle expressed by the former s. 25(e) has been abandoned. The principle was, in the words of that provision, that a deduction should not in any case be made in respect of money not wholly and exclusively laid out or expended for the production of assessable income. Instead of imposing a condition that the expenditure shall wholly and exclusively be for the production of assessable income the present s. 51(1) adopts a principle that will allow of the dissection and even apportionment of losses and outgoings. It does this by providing for the deduction of losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income.”

9.2 The omission of the requirement that an expense must be wholly and exclusively for the purpose of deriving assessable income has some significance. If the phrase remained, an outgoing such as the travel expense referred to in [8.51] above and the entertainment expense referred to in [8.85] above would be denied deduction. The omission of the words has the consequence that the outgoing may be deductible notwithstanding that one of its purposes is not relevant to the derivation of income. If it is deductible, it is deductible as to the whole of its amount.

9.3 But the omission of “wholly and exclusively” is not significant where an expense may be dissected or apportioned. In the United Kingdom, where a “wholly and exclusively” requirement remains (s. 130(a) of the *Income and Corporation Taxes Act* 1970), the view is taken that an expense that can be apportioned may in relation to a part of the expense be seen as wholly and exclusively for the purpose of the derivation of income.
Thus, Lord Reid in *Ransom v. Higgs* [1974] 1 W.L.R. 1594 at 1604 said of the United Kingdom section:

“It seems to me that the section could well be read as meaning that if it can be shown that a part of the expenditure was in fact wholly and exclusively for trading purposes, then that part is a proper deduction.”

What is true in an apportionment situation, is a fortiori true in a dissection situation.

**9.4** The addition of the phrase “to the extent to which” has made no difference to the operation of the general deduction section, where a dissection would be available in any event. Where an expense is capable of dissection, there are in fact several outgoings, and each may be separately judged for deductibility. The significance of the phrase where a dissection would not be available raises questions of the scope of apportionment that would be available in any event, and what further scope for apportionment is given by the phrase. To the extent that apportionment would be available in any event, the phrase simply confirms an aspect of the interpretation of the section.

**9.5** The phrase confirms another aspect of the interpretation of s. 51(1). There is no principle, akin to that in *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341 discussed in [2.558]–[2.569] above, which would allow a deduction of the whole of an outgoing if there is a part of the outgoing which would be deductible if it stood alone, and if the remainder cannot be dissected or apportioned so as to separate it from the part that would be deductible. The consequence of *McLaurin* and *Allsop* is that the whole of a receipt escapes inclusion in income, if there is a part of it which would not be income if it stood alone and the remainder cannot be dissected or apportioned so as to separate it from the part that would not be income. In this regard a narrow view has been taken of what can be apportioned: indeed it is difficult to know when an apportionment, as distinct from a dissection, can be made under *McLaurin*.

**9.6** There is, it is true, some suggestion of a principle in regard to deductibility akin to that in *McLaurin* and *Allsop*, in the judgment of Fisher J. in the Federal Court in *Phillips* (1978) 78 A.T.C. 4361 at 4371:

“It is only if the taxpayer obtains, for a consideration which is identifiable and quantifiable, an additional advantage unconnected with the business activity that it can be said that portion of his expenditure is laid out for a purpose other than the acquiring of assessable income. It is in this circumstance that the identifiable portion would not be an allowable deduction.”

There is no other judicial authority to support such a view, and it is inconsistent with the apportionment ordered by the High Court in *Ronpibon* (1979) 78 C.L.R. 47.

**9.7** The apportionment contemplated by Fisher J. in the passage quoted
from his judgment in *Phillips* may have been intended to state what he thought was the converse of the principle in *McLaurin* and *Allsop*. As such a statement it is as much lacking in precision as the statement of principle in *McLaurin*. As a statement of when an apportionment is proper under the phrase “to the extent to which” it is inconsistent with the judgment of the High Court in *Ronpibon Tin N.L.* (1949) 78 C.L.R. 47 quoted in [9.12] below. *Ronpibon* would support an interpretation of the phrase that would allow and require an apportionment of an outgoing to achieve a number of distinct purposes wherever a separate payment could have been made to achieve that distinct purpose.

**9.8** That interpretation of the phrase would support an apportionment in the circumstances of *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430. A separate payment could have been made to the supplier of the shoes to serve the purpose of conferring a benefit on the shareholders of that company beyond a payment for the shoes. An apportionment in these circumstances is on its face required by s. 51(1) so as to deny the deduction of some part of what was paid. In *Cecil* and later cases this has become obscured by the approach described as extended form and blinkers and explained in [9.17] ff. below.

**9.9** *Ure* (1981) 81 A.T.C. 4100 would support a view that the phrase makes a further extension of the requirement to apportion. *Ure* is an illustration of a number of circumstances where deductibility of what might be seen as a service cost of the holding of property is made to depend on the use that is made of the property. *Ure* was concerned with interest on money borrowed and used to serve distinct purposes only some of which related to the derivation of income. Other circumstances will involve the letting of property to serve such purposes, or the use of property directly for distinct purposes, of which the home-study cases considered in [8.28]ff. above afford illustrations. In all these circumstances some separate action is open to the taxpayer that will give effect to the purpose to derive income or the purpose that does not relate to the derivation of income. In *Ure* the taxpayer might have lent some of the money borrowed at a commercial rate of interest and made an interest free loan of the remainder. In the circumstances of a letting of property partly out of charity, the taxpayer might have let at a commercial rent and made a gift to the tenant of the amount of rent foregone in the charity letting.

**9.10** *Ure* does not however support a view that the phrase “to the extent to which” requires an apportionment in the circumstances of the travel expense referred to in [8.51] above, the entertainment expense referred to in [8.88] above and the health expense referred to in [8.16] above. Nor would it support a view that apportionment is required in the circumstances

**Where the Issue is Relevance of an Expense**

9.11 It is the view of this Volume that where an issue is raised as to the relevance of an expense, a decision to compromise by apportioning and allowing a deduction of part of the expense is not appropriate. In circumstances such as *Magna Alloys & Research Pty Ltd* (1980) 80 A.T.C. 4542, if the board of directors is moved in part by a purpose of conferring a gratuitous benefit on the officers of the company—a benefit that is not a reward for services—it is not appropriate to allow a deduction of some part of the expense. A decision must be made as to the whole expense. An apportionment would simply express a doubt about relevance: it would not identify an element within the expense that is relevant to income derivation. Meeting the expenses of the company's officers for the purposes of furthering the company's interests could not have been the subject of an expense distinct from the expense of conferring a gratuitous benefit on the company's officers by meeting the expenses. The same point has already been made in regard to a travel expense ([8.51] above), in regard to a health expense ([8.16] above), and in regard to an entertainment expense ([8.88] above). A health expense may be incurred for the purpose of restoring some bodily function necessary to the derivation of income, and for the purpose of restoring a bodily function which contributes to the taxpayer's well-being. But an apportionment is not appropriate. A medical expense for the first purpose could not be made the subject of a payment distinct from the payment to serve the second purpose. If it be assumed that a purpose of regaining a bodily function for use in income derivation may give relevance to an expense, it can give relevance to the whole of the expense, but not to a part of it.

9.12 In *Ronpibon Tin N.L.* (1949) 78 C.L.R. 47 the High Court made some observations on the appropriateness of apportionment when “the problem is to apportion outgoings which have a double aspect, outgoings that are in part attributable to the gaining of assessable income and in part to some other end or activity”. The court observed (at 59):

“...It is perhaps desirable to remark that there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kind of apportionable items consists in those involving a single outlay or
charge which serves both objects indifferently. Of this directors' fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or ratable division because it is common to both objects.”

Those observations may be thought to conflict with the principle that one cannot express a doubt about relevance by apportioning an expense and allowing a deduction of part of the expense. So far as directors' fees are concerned, there is no conflict with the principle. “Arithmetical or ratable division” may not be possible, but it is none the less possible to contemplate a separate payment being made to directors for work that is relevant to the derivation of income by the company and a separate payment for work that is not. Nor is there any conflict with the principle in the observation, in relation to the expenses of things or services, that apportionment may be made in accordance with the application of those things or services. The services of lawyers in Magna Alloys were not the subject of distinct applications by the company. They were applied only in the defence of the company's officers. Where an apportionment is proper so as to allow a deduction of that part of an expense that serves a purpose that will justify deductibility, the appropriate amount to be apportioned to the service of that purpose is not necessarily the amount that would have been paid to serve that purpose alone. To apportion in this way would in effect be to allow deduction of a notional expense. The view of Kitto J. in Western Suburbs Cinemas Ltd (1952) 86 C.L.R. 102 in relation to deductibility under the specific provisions of s. 53 that a notional expense is not deductible, is equally applicable to deductibility under s. 51 (1). The view of Kitto J. is considered in [9.14] below. Where a taxpayer whose own travel expenses are deductible pays for a double room and shares with his wife, he is not necessarily entitled to a deduction of what he would have paid for single occupancy of that room, or for occupancy of a single room.

Where the Issue is the Working Character of an Admittedly Relevant Expense

9.13 A principle has been asserted above that an apportionment may not be made so as to express a doubt about relevance. There is a similar principle when the issue is the working character of an expense. One cannot save an expense from denial of deduction as a non-working expense by apportioning the expense and allowing a deduction of part of it as a working expense. Every element in the expense, unless it can be shown that there is an element whose purpose or function is working, will retain its character as non-working despite the apportionment. The expenses of a massive advertising campaign directed to an extension of business goodwill is very likely a non-working expense. If it is, an apportionment is not available so as to allow a deduction of an amount the taxpayer might have spent had his purpose been merely to maintain existing goodwill. Apportionment could not, in regard to the amount apportioned and claimed to be working, change the character of the expense.
9.14 An expense for repairs to property used for the purpose of producing income may be denied deduction as a non-working expense. It would not be appropriate to apportion the expense and allow a deduction of a part which, if it were the repair expense, would have been a working expense. The fact that s. 51(1) includes the phrase “to the extent to which” does not require a different operation for s. 51(1) from that given to the specific provision in s. 53 by the decision of Kitto J. in Western Suburbs Cinemas Ltd (1952) 86 C.L.R. 102. Kitto J., in denying a deduction of the whole expense, refused to allow a deduction, under s. 53, of a lesser amount than the expense incurred, the lesser amount being what the taxpayer asserted he would have spent had he repaired in a way that did not involve an improvement. The interpretation of s. 53, it will be seen, has identified non-working or capital expenses by way of repairs as expenses which involve an improvement or the reconstruction of an entirety. The decision of Kitto J. is put on the ground that no deduction is allowable for a “notional” expense—an expense the taxpayer might have incurred, but did not incur. It might equally have been put on the ground that part of a repair expense is not deductible when the whole expense is denied deduction, whether as an improvement or a reconstruction of an entirety. The line between an expense for restoration of a part which is a working expense, and an expense for reconstruction of an entirety, which is not a working expense, may not be easy to draw, but any part of an expense whose purpose is to reconstruct an entirety must have the purpose of the whole and an apportionment to allow deduction of a part is not appropriate. Apportionment and the allowing of a deduction of part of the expense would simply destroy the principle that the reconstruction of an entirety is not a working expense. Each and every apportioned part of the expense, would qualify as a repair. Apportionment would not wholly destroy the principle that an improvement is not a working expense. It would still be possible to deny a deduction of that part of the expense that may be said to improve—the fibrous plaster ceiling in Western Suburbs Cinemas. None the less apportionment so as to define and allow deduction of other parts of the expense which do not improve, is not appropriate. Apportionment cannot take away the character that each part has, as part of an expense that does improve.

9.15 The analysis that is here adopted in regard to an apportionment will equally apply to a dissection, where dissection can be made. A dissection will give rise to several outgoings, each calling for judgment as to relevance and working character. But it may not be possible to distinguish the purpose of each such outgoing from the purpose of the others. It is in these circumstances that allowing a dissection so as to justify deduction of
one of the outgoings would be to override the principle that an expense, to be deductible, must be a working expense. The builder who reconstructed the entire slipway in Lindsay (1961) 106 C.L.R. 377 might have quoted and charged separately for replacing distinct sections of the slipway, so that the total charge could be dissected. None the less each outgoing would take its character from the total charge. There will of course always be a question whether the outgoings identified by the dissection are related by one purpose. A number of outgoings for repairs may, in the aggregate, have the effect of reconstructing an entirety. They are not necessarily related by one purpose whose concern is to reconstruct the entirety.

9.16 An illustration of a proper apportionment which will identify some part of an expense as a working expense is afforded by the facts of Ronpibon Tin N.L. (1949) 78 C.L.R. 47. The fees of directors and the legal manager of the company were paid for services which related in part to the non-working purpose of re-establishing the company's mining business in South-East Asia after the war and in part to the working purpose of maintaining the company's current investment activity. The identifying by an apportionment of how much was paid for the latter purpose does not challenge the principle that a non-working expense is not deductible under s. 51(1). The amount apportioned to the working purpose does not when apportioned retain any of the purpose it might have had by its association with that part of the expense that had a non-working purpose.

The Bearing of Extended Form

9.17 The appropriateness of apportionment depends on a conclusion that the expense has as one of its purposes, a purpose that would give the expense a working character if it were the sole purpose of the payment. It is implicit that there is another purpose which does not support relevance or working character. A number of references have been made in earlier paragraphs of this chapter to a judicial approach characterised as “form and blinkers”. In the context of outgoings, this approach limits the circumstances that may be considered in seeking a conclusion as to the purpose of an outgoing. The approach begins with the adoption of a rule, for example that the cost of purchasing trading stock is a relevant and working expense (Cecil Bros Pty Ltd (1964) 111 C.L.R. 430, Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2) (1976) 76 A.T.C. 6001) or that rent of premises used in a process of income derivation is a relevant and working expense (South Australian Battery Makers Pty Ltd (1978) 140 C.L.R. 645). The approach then takes the view that when the taxpayer's actions involve the adoption of some legal form, for example a contract to buy or a lease,
which in its terms identifies an expense as a cost of purchasing stock or as rent for premises, the rule must be taken to be satisfied and circumstances other than the legal form may not be considered so as to question the satisfaction of the rule. Some strange consequences follow from the approach. In *Europa Oil (No. 2)* the Privy Council had need to explain a statement in *I.R.C. (N.Z.) v. Europa Oil (N.Z.) Ltd (No. 1)* [1971] A.C. 760 at 772 that “the Crown is not bound by the taxpayer's statement of account, or by the heading under which expenditure is placed. It is entitled to ascertain for what the expenditure was in reality incurred.” The explanation given is that “the reference to ‘reality’ was directed only to the legal character of the payment and not to its economic consequences” (1976) 76 A.T.C. 6001 at 6007). The explanation asserts a distinction between legal reality and commercial reality or, as it is also called in the Privy Council judgment in *Europa Oil (No. 1)*, “economic equivalence” (at 772). The idea of levels of reality is at the least mystifying. The irrelevance of commercial reality was earlier asserted in *Cecil*, despite an acknowledgement by the court that a purpose in the purchase of the shares from the family company was to divert profit to that company. The approach invites, for example, the obtaining of a deduction for a contribution to a political party by making the contribution in the legal form of a payment for an advertisement in the party's journal, the payment being an over-payment for the advertising service.

9.18 The form and blinkers approach has been questioned in earlier paragraphs on two fronts. There is no warrant for treating a rule that may, in most circumstances, be a useful expression of the principles expressed in s. 51(1), as if it were part of the statute itself. Second, there is no warrant for treating the adoption of a form suggested by the rule as excluding all other circumstances from which a conclusion might be drawn that the principles expressed in s. 51(1) do not justify deductibility of the expense. Lord Wilberforce dissented in *Europa Oil (No. 2)*, though he had been a member of the majority in *Europa Oil (No. 1)*. His dissent asserted that it is too narrow a view of *Europa (No. 1)* “to confine the decision to a case where the benefit obtained by the expenditure is contractually secured in the sense that as part of the purchasing contract, or even as a part of a separate but integrated contract the seller agreed with the buyer to pay it” ((1976) 76 A.T.C. 6001 at 6013). He affirmed (at 6013) an approach which would look to reality beyond legal reality: “What was the expenditure for? What was it intended to gain? What did it gain? What elements entered into the fixing and acceptance of it? These are the questions to be asked. To rephrase this so as to ask, ‘What did the other party legally bind himself to pay or do’, is to confine the cases where no
deduction is allowed to one special case: to substitute a legalistic test for a commercial test. I think in this context of the often quoted words of Dixon J. [in *Hallstroms Pty Ltd v. F.C.T.* (1946) 72 C.L.R. 634] where he said in a different but analogous context that what is an outgoing of capital and what is an outgoing on account of revenue depends on ‘what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured . . . in the process’” (at 648).

9.19 There are indications in judgments of the High Court and of the Federal Court of a retreat from the form and blinkers approach. Gibbs A.C.J. in *South Australian Battery Makers* (1978) 140 C.L.R. 645 adopted a qualification which will allow reference to a benefit which the person incurring the expense has in fact derived, even though that benefit is not stipulated for in the terms of the legal form that has been adopted. It is true that the concept of benefit in the qualification adopted by Gibbs J. is a narrow one. The acquisition of property by a company that is a subsidiary of the taxpayer, is a benefit for purposes of the qualification. Jacobs J., in dissent, adopted the qualification, but took a less restricted view of “benefit”.

9.20 Gibbs J. thought that a qualification on the form and blinkers approach taken by the majority in *Europa (No. 2)* (which it should be noted was a New Zealand appeal) was called for so as to give significance to the judgment of Dixon J. in *Hallstroms*, more especially to the judgment in the passage cited by Lord Wilberforce in *Europa (No. 2)*. It is true that Dixon J. was not concerned with a question of relevance, but with a question of working character. There is, however, no reason why the form and blinkers approach should be the more applicable on questions of relevance than on questions of working character.

9.21 The retreat from the form and blinkers approach is the more evident in the Federal Court. In [6.84]–[6.85] above there is some discussion, in this regard, of the judgments of the Federal Court in *Total Holdings (Australia) Ltd* (1979) 79 A.T.C. 4279 and at first instance in *Ure* (1981) 81 A.T.C. 4100. The retreat is not a conscious retreat. Only Lee J. at first instance in *Ure* thought the form and blinkers approach was applicable where the question is not the maintenance purpose in the payment of interest for the use of money borrowed, but the purpose of the use made of that money, a purpose which, accessorially, bears on the purpose of the interest payment. But there is none the less a retreat. It is not possible to frame a reason why the approach should apply when the question is the maintenance purpose in the payment of interest, but not when the question is whether the payment has a purpose of serving the derivation of income.
9.22 The retreat from form and blinkers increases the room for apportionment of expenses. Thus, in a *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430 situation an apportionment may be appropriate so as to deny a deduction of so much of the ostensible outgoing for trading stock as was incurred for the purpose of conferring a gratuitous benefit on the associated company and its shareholders. If an objective approach is taken to determination of purpose, an inference of such a purpose should be drawn from the fact of association between the companies and a higher payment made for the goods than the payment that would have been made to obtain them in an arm's length transaction. An apportionment is, in other respects, appropriate on the facts in *Cecil*, because a separate payment could in theory have been made to serve the purpose of obtaining the supply of trading stock. There would be no departure from the principle that an apportionment may not be used to reflect a doubt about relevance.

9.23 An apportionment becomes appropriate to allow deduction of some of the expense in facts such as *Europa Oil (No. 2)*, but to deny deduction of the expense so far as it was incurred for the purpose of securing that payments would be made to the taxpayer's associated company in the Bahamas.

9.24 Despite the retreat from form and blinkers, an apportionment so as to deny part of the expense may remain inappropriate in facts such as in *Phillips* (1978) 78 A.T.C. 4361. The trial judge in that case found that the payment to the family trust for the services provided by the trust to the partnership were, in amount, what would have been paid for the same services to an arm's length supplier. On this finding there was no basis for an objective inference that some part of the expenses incurred had the purpose of providing the family trust with a gratuitous benefit. No doubt doing business with a family trust made possible the making of profits by the trust, but this would be equally true of doing business with an arm's length supplier.

9.25 An inference of purpose other than securing the supply of goods or services will be appropriate where there is an association between the parties to the transaction and the amount of the outgoing exceeds a market value of the goods or services. And an inference may be drawn where a collateral benefit sought by the taxpayer is in fact obtained by the taxpayer who incurs the outgoing, or by some third party, even though the parties to the transaction are not associated and the amount of the outgoing does not exceed a market value.

9.26 If it is thought that the demise of form and blinkers and the letting in of apportionment will upset what may be seen as the legitimate shifting of profits between associated commercial enterprises, the restoring of scope
for such shifting should be achieved by specific statutory provisions, such as pro-such shifting should be achieved by specific statutory provisions, such as the provisions now adopted allowing shifting of losses between wholly owned subsidiaries in a group of companies (s. 80G).

The Arithmetic of Apportionment

9.27 Some of the judicial support for a form and blinkers approach might be explained by an unwillingness to multiply tasks of calculation, and arguments about calculations, that must arise when apportionment is let in. Provided that an objective approach to the determination of purpose bearing on deductibility comes to be established, the occasions of calculation will, however, be limited. Where they have to be made, the manner of their making is likely to be suggested by the facts. In Cecil the facts suggest the denial of a deduction of the difference between what was paid for the shoes by the taxpayer and what was paid for them by the associated company. In Europa Oil (No. 2) the facts suggest a denial of a deduction to the extent of the profit diverted to the associated company. In South Australian Battery Makers the facts suggest the denial of a deduction to the extent of the increase in the value of the option to acquire the property. There will be room for argument about calculation only where the item is one involving a “single outlay or charge which serves both objects indifferently”. Of that situation the High Court said in Ronpibon Tin N.L. (1949) 78 C.L.R. 47 at 59–60:

“... there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or ratable division because it is common to both objects. In such a case the result must depend in an even greater degree upon a finding by the tribunal of fact. The reason why the commissioner has adopted the practice of allowing two and one-half per cent on income from investments as a deduction is no doubt because generally speaking it has been found to produce an adequate allowance and because he is forced by the exigencies of administration to provide his assessors with some fixed rule. But it is a more or less arbitrary expedient to which it is scarcely possible to resort judicially when the court is called upon to decide an appeal from an assessment. The court must make an apportionment which the facts of the particular case may seem to make just, and the facts of the present cases are rather special. In making the apportionment the peculiarities of the cases cannot be disregarded. The taxpayers are companies. A directorate is necessary. The circumstances were such as to call for some consideration from time to time on the part of the directors of the investment of the money. Thus although the assessable income is only interest on government loans and fixed deposits, it is by no means a mere question of fixing a fair commission rate for handling the business. It is important not to confuse the question how much of
the actual expenditure of the taxpayer is attributable to the gaining of assessable income with the question how much would a prudent investor have expended in gaining the assessable income. The actual expenditure in gaining the assessable income, if and when ascertained, must be accepted. The problem is to ascertain it by an apportionment. It is not for the court or the commissioner to say how much a taxpayer ought to spend in obtaining his income, but only how much he has spent: see per Ferguson J. in Tooheys Ltd v. C. of T. (1922) 22 S.R. (N.S.W.) 432 at 440; per Williams J. in Tweddle (1942) 7 A.T.D. 186 at 190. The question of fact is therefore to make a fair apportionment to each object of the companies' actual expenditure where items are not in themselves referable to one object or the other. But this must be done as a matter of fact and therefore not by this Full Court.”

9.28 *Ronpibon Tin N.L.* in the passage just cited, is a source in High Court judgments, of a dictum which has confused and confounded judicial decision: “It is not for the court or the commissioner to say how much a taxpayer ought to spend in obtaining his income.” Some observations on the dictum were made in [6.6] and [9.17]–[9.26] above. It should be observed that the effect of an apportionment, on the demise of the form and blinkers approach, will not be to tell the taxpayer how much he should spend. The effect will be to determine how much he has spent. This was the effect of the apportionment directed in *Ronpibon Tin* itself.

**Specific Statutory Provisions Allied to Apportionment**

9.29 The Assessment Act has included from an early stage in its history provisions which empower an apportionment, and a denial of a deduction of some part of an expense, in circumstances involving payments between associated persons: ss 65, 108 and 109. The existence of those provisions, more especially s. 65, has indeed been pointed to as confirming the form and blinkers approach. It is said that there is an implied rejection of apportionment under s. 51(1) in relation to such payments, by the express provisions for apportionment in those sections.

9.30 Section 31c is a newcomer which provides expressly for an apportionment and the denial of some part of a deduction in the circumstances of *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430—a payment to a “connected” person for trading stock. It was inserted in the Act following the decision in *Isherwood & Dreyfus Pty Ltd* (1979) 79 A.T.C. 4031 which applied *Cecil* and *Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.)* (No. 2) (1976) 76 A.T.C. 6001.

9.31 The most recent additions to the Act are ss 82KH, 82KJ and 82KL and Pt IVA. Sections 82KH, 82KJ and 82KL are an attempt to overcome the tax planning which followed the confirmation of the form and blinkers approach in *Europa Oil (No. 2)* and *South Australian Battery Makers Pty*
LTD (1978) 140 C.L.R. 645. The demise of form and blinkers will make these provisions unnecessary. One role of Pt IVA, which replaces the general provision against tax avoidance in s. 260, is to overcome tax planning that relies on form and blinkers.

9.32 Sections 31C, 65, 82KH, 82KJ and 82KL, 108, 109 and Pt IVA are the subject of closer examination in Chapters 10 and 16 below.
Chapter 10: Specific Provisions Confirming, Extending or Qualifying Deductibility Under Section 51(1)

10.1 The Assessment Act contains a great number of specific provisions which may be seen as confirming, extending or qualifying deductibility under the general provisions of s. 51(1). Some of these provisions, for example ss 28, 36 and 51(3), directly concern matters of tax accounting which are considered in Part III, and are excluded from present consideration. Some provisions which do not have any current operation, or depend for their operation on legal relations having been entered into in the past, for example Div. 4 of Pt III relating to leases, are also excluded from present consideration. Provisions which relate only to the affairs of particular industries, for example those contained in Div. 10 (General Mining), are listed but are not discussed. Discussion is for the most part confined to provisions which raise some question of correlation with s. 51 (1), or some matter of comparison or contrast with the operation of s. 51 (1).

10.2 A specific provision in providing for a deduction may confirm in some respect the operation of s. 51(1), or confirm and extend its operation, or it may provide for a deduction also provided for under another specific provision. Where it does, an item of expense is deductible under more than one provision, and there is need of a provision that will determine which is to be applied, or indeed, that both are to be applied. Such provisions are found in s. 82, and in s. 82AM in relation to the investment allowance. They are surveyed at the outset of discussions that follow: [10.4]ff. below.

10.3 The classification of specific provisions adopted is:

(i) Provisions confirming and, possibly, extending the operation of s. 51(1), for example s. 53 relating to repairs;
(ii) Provisions allowing deductions of expenses that are beyond the operation of s. 51(1) because they provide for a deduction of an expense not yet incurred, for example s. 63 relating to bad debts, or for the deduction of an expense that is not necessarily relevant to the derivation of income, for example s. 73 relating to subscriptions to associations;
(iii) Provisions allowing deductions of expenses that are beyond the operation of s. 51(1) because, though relevant, they are not working expenses, for example ss 54–63 relating to depreciation;
(iv) Provisions which displace the operation of s. 51(1) by defining codes in relation to certain classes of expenses, for example, Subdiv. AA of Div. 3 of Pt III relating to employer contributions to superannuation funds;
(v) Provisions allowing deduction of “notional” expenses—expenses that do not
involve any loss or outgoing in the year of income, for example ss 80–80F relating to the carry forward of losses;

(vi) Provisions denying deductions otherwise allowable under s. 51(1), for example s. 65 relating to payments between connected persons; and

(vii) Provisions allowing deductions of expenses of particular industries, for example those contained in Div. 10 of Pt III relating to general mining.

Within each classification, sections are dealt with in the order in which they appear in the Act. The choice of sections to be included in each classification is tentative. The inclusion of a section assumes, in some instances, answers to questions in regard to the correlation of a section with s. 51(1) which call for discussion. Thus s. 53 is classified as a section confirming a part of the operation of s. 51(1). In fact it may be a specific provision displacing the operation of s. 51(1). In which event, it would be necessary to specify the area over which s. 53 may be regarded as a code. To the extent that s. 53 displaces the operation of s. 51(1), it should be included in the classification adopted for such provisions.

Expenses Deductible Under More Than One Provision, or Deductible under one Provision and Subtractable in Computing a Profit that is Income or a Loss that is Deductible

10.4 An expense may be deductible under s. 51(1) and under some specific provision, or it may be deductible under two specific provisions. Section 51(1) and s. 53 relating to repairs (on the assumption that it is not a code), or s. 51(1) and s. 72, relating to rates and taxes, afford illustrations of the former. Sections 54ff. relating to depreciation and s. 82AB giving an investment allowance, is an illustration of the latter.

10.5 Sometimes the Act allows the taxpayer to deduct the same expense twice. Section 82AM, relating to the investment allowance, is an illustration. The general provision is, however, expressed in s. 82: “where in respect of any amount, a deduction would but for [s. 82] be allowable under more than one provision of [the] Act, and whether it would be so allowable from the assessable income of the same or different years, the deduction shall be allowable only under that provision which in the opinion of the Commissioner is most appropriate.” The general provision in s. 82, by which a discretion is given to the Commissioner, contrasts with a number of provisions in relation to particular industries, by which an option is given to the taxpayer to take a deduction for depreciation under s. 54ff. or to take a deduction under the particular industry provision—ss 122N(2), 123E(2) and 124JC(2).

10.6 The Commissioner's discretion is important when a deduction is
allowable under s. 51(1) and under one of the sections referred to in s. 79C, which imposes a limitation on the deductibility of expenses deductible under those sections. The reference to a deduction “in respect of the amount” allowable under more than one provision in the Act raises a question whether two deductions are in respect of the same amount. Two deductions may be in respect of the same amount, though they have been incurred in different years. A taxpayer may not have claimed a deduction under s. 63 for a write-off of a bad debt in an earlier year, and now claims a deduction for a loss in respect of the debt under s. 51(1). It may be asked whether the latter deduction is in respect of the same amount as the deduction for a write-off. If it is, the Commissioner may have a discretion to refuse to allow the s. 51(1) deduction, asserting that the s. 63 deduction is the more appropriate, and the taxpayer may in the result be denied any deduction because amendment of the assessment of the earlier year is not, in the circumstances, within the power of the Commissioner under s. 170 (4). “Allowable” presumably means allowable on the facts as they are: if the taxpayer has not written off the specific debt in the earlier year, there may be no room for the Commissioner's discretion under s. 82.

10.7 An expense may, prima facie, be subtractable, in computing the amount of a profit that is income, or the amount of a loss that is deductible, under s. 51(1) or s. 52. Such an expense may also be an outgoing deductible under some specific provision, for example s. 75A relating to land used in carrying on a business of primary production. Section 82(2) expressly denies the subtraction of the outlay in computing the profit or loss, if the outlay was an outgoing deductible under a specific provision. Section 82(2) would in its terms extend to deny the subtraction of an outlay that was deductible under s. 51(1). It will appear from the analysis in [5.15], [5.36] and [7.11] above that an outlay on a wasting revenue asset may be deductible under s. 51(1), for example an outlay on the oil company tie in B.P. Australia Ltd (1965) 112 C.L.R. 386. The outlay will not be subtractable in computing the profit that is income on the realisation of the wasting revenue asset or the loss that is then deductible. The prospect of a loss will be confined to a case where the cost of the revenue asset was properly deductible over a period of years, and the amount of the proceeds on realisation of the asset is less than the amount of the cost that has not, at the time of realisation, been allowed as a s. 51(1) deduction. Whether s. 51(1) requires the cost of a wasting revenue asset to be spread forward over the years of consumption of that cost in the use of the asset, is a matter explored in [7.11]–[7.16] above.

Provisions Confirming and, Possibly, Extending the Operation
of Section 51(1)

Section 53: repairs to property used for the purpose of producing assessable income

10.8 The deductibility under s. 51(1) of expenses for repairs to property used for the purpose of producing assessable income was considered in [6.149] and [6.159] above. The view there taken is that expenses for repairs may be relevant if the property is used by the taxpayer for the purpose of producing assessable income, and they will be working expenses if they are maintenance expenses. The notion of use for the purpose of producing assessable income in such a statement of principle is the subject of comment in [6.114]–[6.116] above. Where property is let to another at less than a commercial rent, the purpose of the letting being in part to confer a gratuitous benefit on the tenant, there are mixed purposes in the use and an apportionment is required. Whether repair expenses are working expenses will depend on the application of principles considered in [7.1]ff. above. Issues of working character will arise in relation to expenses that “improve” or “reconstruct an entirety”, in the language of decisions on s. 53.

10.9 In fact there is no judicial decision on the operation of s. 51(1) in relation to repairs. All decisions are concerned exclusively with the operation of s. 53. It might be inferred from this that s. 53 is assumed to be a code displacing the operation of s. 51(1). Some inference of an intention that s. 53 is a code might be drawn from the express denial by s. 53(2) of deduction of expenditure incurred upon repairs to any premises or part of premises not held, occupied or used for the purpose of producing assessable income. If s. 53 is held to be a code, there will be a need to define the area covered by the code, from which s. 51(1) is excluded. So long as the issues raised by s. 53 are those that would be raised in any event by s. 51(1) the extent of displacing of s. 51(1) is of no practical significance. To the extent that s. 51(1) has some wider operation than s. 53, the extent of displacing becomes critical. In [6.157] above there is some discussion of a wider operation for s. 51(1) than the operation of s. 53 where repairs are effected by a tenant who does not have tenant rights. Section 53 may in some respects have the wider operation. To this extent the question whether it is a code is not important. The section may not require contemporaneity of the incurring of an expense and the holding or use for the purpose of producing income, as s. 51(1) requires. And the connection between the expense and the holding for the purpose of producing income that will make the expense relevant may be
10.10 Some comparison of the scope of s. 53 in regard to repairs and of s. 54ff. in regard to depreciation is instructive. A deduction may be available for repairs to a building (“premises”) under s. 53, while depreciation is available only in respect of “plant or articles”, words that, in the absence of express extension, do not cover buildings (“structural improvements”) that are not “plant”. A taxpayer may be entitled to a deduction for repairs to property he uses to produce assessable income, even though he does not own that property. Depreciation is available only to the owner of property.

10.11 An expense for repairs may be deductible under s. 53, and be a cost of a unit of property that is depreciable under s. 54ff. The deduction for repairs is allowable, but the amount of that deduction is excluded by s. 57(3) from the costs for purposes of depreciation: there is thus no room for the operation of s. 82.

10.12 An expense for repairs that is not deductible under s. 53 because it is an improvement or the reconstruction of an entirety, is not necessarily a cost of a unit of property depreciable under s. 54ff. The unit of property may not be plant or articles—it may be a structural improvement that is neither plant nor deemed to be such by the definition of plant in s. 54(2). The taxpayer may not be the owner of the property. In this instance the taxpayer is not entitled to a deduction for repairs or for depreciation. There is thus a possible penalty in the denial of any deduction, save under Div. 10C or Div. 10D of Pt III, if repairs to a structure are an improvement or a reconstruction of an entirety, or in the denial of any deduction, if repairs to any property are an improvement or a reconstruction of an entirety and the taxpayer is not the owner of the property. Divisions 10C and 10D are dealt with in [10.212]ff. below.

10.13 A number of principles that emerge from the interpretation of s. 53 call for some comment. Two of them have already been referred to: the “reconstruction of an entirety” as distinct from the restoration of a part is not a deductible repair, and an “improvement is not a repair”. A third principle asserts that an “initial repair” is not deductible: an expense that is to be seen as a cost of the acquisition of the property repaired is not deductible. A fourth principle asserts that there is no deduction for a “notional” repair: there is no deduction under s. 53 for an expense that the taxpayer might have incurred but did not incur.

10.14 The first three principles raise a question as to the structure of s. 53, akin to a question discussed at length in [5.8]–[5.12] above about the structure of s. 51(1). The first and third principles tend to assume that an item may be a repair but is excluded from deduction by the exclusion of expenditure of a capital nature. The second, in its formulation, assumes an
analysis of the structure of s. 53 of the kind adopted in this Volume in relation to s. 51: an item is not a repair unless it is a working—in this instance a maintenance— expense. The exclusion of expenditure of a capital nature merely emphasises that a non-working expense is not a repair expense. Important consequences turn on what may be the correct analysis of the structure of s. 51(1), more especially when the significance of the exceptions of private or domestic outgoings is the issue raised. It may indicate that there are no consequences which depend on the correct analysis of the structure of s. 53 that differing analyses are reflected in the principles as they are asserted. The word repair is used in this Volume in a way that will include an item that can be denied deduction because it is not working. The correctness of the analysis that the language assumes remains unresolved.

An expense of the reconstruction of an “entirety” is not a deductible repair

10.15 The concept of an “entirety” which is central to this principle is indeterminate. The phrases that are used in the cases to identify an entirety—“separately identifiable as a principal piece of capital equipment” and “a physical thing which satisfies a particular notion”—are circular. The phrase used in the statutory provisions governing depreciation (s. 56) and the investment allowance (s. 82AB) is “unit of property”, and discussions on the meaning of that phrase may have some bearing. Ready Mixed Concrete (Victoria) Pty Ltd (1969) 118 C.L.R. 177 adopts a notion of “functionally complete” as the meaning of “unit”. But the conclusion in Lindsay (1961) 106 C.L.R. 377 that the slipway was an entirety could not be explained on the ground that it was functionally complete. Western Suburbs Cinemas Ltd (1952) 86 C.L.R. 102 may support a conclusion that a ceiling in a theatre is an entirety, but again it is not easily regarded as an item that is functionally complete. The question whether or not a water tank in a building is an entirety, so that its replacement is not a repair, remains a matter of debate between taxpayer and the Commissioner. If the item is an entirety it may yet be difficult to regard it as a unit of property, so that the cost may be deductible if the item is plant. And it may not be plant. The notion of plant is examined in [10.142]ff. below in connection with ss 54ff. The debate between taxpayer and Commissioner proceeds in the rhetoric of indeterminates.

10.16 An expense which has as its purpose the reconstruction of an entirety may not be dissected or apportioned so as to allow a deduction of parts of the expense attributable to work which does not amount to reconstruction of an entirety. There is no express provision for dissection or
apportionment in s. 53 that is applicable in these circumstances. To dissect or apportion and allow a deduction of any part of the expense would simply destroy the principle that the reconstruction of an entirety is not a deductible repair. The expense in a Lindsay situation does not become deductible by apportioning it into parts referable to different sections of the slipway. There is of course a difference between the facts in Lindsay and facts which would involve the expense of the progressive restoration of part of the slipway over a period of time. Progressive restoration may involve a number of repair expenses, each deductible. The line between an expense or a number of expenses which have a single function of reconstruction of an entirety, and an expense or a number of expenses, which have several functions, each no more than restoration of a part, will not always be easily drawn. In Rhodesia Railways Ltd v. C. of T. (Southern Rhodesia) [1925] 1 S.Af. T.C. 133, the restoration of sections of a railway track was held not to be the reconstruction of an entirety. But restoration, whether or not the subject of distinct expenses, carried out over a short period of years and not in pursuance of an on-going programme of restoration may well be held to involve the reconstruction of an entirety.

An “improvement” is not a repair

10.17 Lindsay (1961) 106 C.L.R. 377 is authority that a repair expense does not improve merely because the material used is more expensive than the original material, or because some addition or alteration to the thing repaired is involved. In Lindsay it was held that a concrete slipway replacing a wooden slipway did not involve an improvement, and this notwithstanding that the new concrete slipway was longer than the original. 10.18 To be an improvement the repair must involve a significantly greater efficiency in function—an acoustic ceiling replacing an ordinary ceiling—or a significant reduction in the incidence of future repairs—copper guttering replacing steel guttering, or a concrete floor replacing a wooden floor subject to rotting because of dampness. This concept of improvement was the subject of comment by Danckwerts J. in Thomas Wilson (Keighley) Ltd v. Emmerson (1960) 39 T.C. 360. He saw it as discouraging the proper use of resources. The effect is to give a tax subsidy to what was the less efficient use of resources. Sometimes a lesser subsidy—it will be deferred—will be given through depreciation. Where the property repaired is a building that is neither plant nor deemed to be plant there will be no subsidy through depreciation though there may be a lesser subsidy under Divs 10C and 10D of Pt III.

10.19 Greater efficiency in some existing function will make a repair an
improvement. There is a question suggested by the judgment of Windeyer J. in *W. Thomas & Co.* (1965) 115 C.L.R. 58 whether a repair that adapts property to a new function is an improvement. A building in need of painting, and presently painted in a dark colour appropriate to its use as a store, may be re-painted in a light colour appropriate to the intended use of the building as a factory. A store may be cleaned so as to adapt it to its intended use as a factory.

**10.20** A repair may involve greater efficiency in function or greater durability as to some part only of the work done in the repair. There is a question whether the expense may be dissected or apportioned so as to allow a deduction of so much of the expense as does not relate to work that improves. The question was raised in [9.14] above where the view is expressed that an apportionment is not appropriate. In the words of Kitto J. in *Western Suburbs Cinemas Ltd* (1952) 86 C.L.R. 102 at 109 “if a total expenditure is of a capital nature, so is every part of it”. The identification of the “total expenditure”, as those words are used in *Western Suburbs*, poses problems. If it be assumed that a ceiling in a theatre is not an entirety, the denial of a deduction for repairs by replacing the ceiling must depend on the replacement being an improvement. The replacement may involve new joists and battens which are of the same material as the old, and a new surface which is different from the old and is more durable. A conclusion that there are in effect two repairs, and that the expenses referable to the joists and battens should be apportioned, may be open.

**An “initial” repair expense is not deductible**

**10.21** The scope of the principle that an initial repair expense is not deductible depends on the meaning that may be given to the work “initial”. A repair is not an initial repair simply because it is the first repair to the property since the acquisition of the property. Nor is it an initial repair simply because it restores property that has suffered some deterioration as a result of use prior to its acquisition by the taxpayer, even though that deterioration is the major part of the deterioration made good by the repair. *W. Thomas & Co.* (1965) 115 C.L.R. 58 may stand for a principle that a repair after acquisition is an initial repair, if repair was “due” at the time of acquisition of the property, in the sense that there was a need for repair judged by standards of good husbandry of property. Whether *W. Thomas & Co.* in this respect correctly reflects the decision of the House of Lords in the *Law Shipping Co. Ltd v. I.R.C.* (1923) 12 T.C. 621 may be the subject of some debate. In that case the vessel could not be used on any new voyage after its acquisition, until it had been surveyed and repairs directed
by the survey had been carried out. This may suggest a meaning of “initial” which would confine non-deductible repairs to those that are necessary to make possible the continued functioning of the property repaired. Such a meaning of “initial” may appear to have been adopted by the English Court of Appeal in Odeon Associated Theatres [1973] Ch. 288, though there is considerable emphasis in the case on whether an accounting convention would require that the expense be “capitalised”, that is, treated as a cost of acquisition and not as a revenue expense.

10.22 An “initial” repair expense is a non-working expense. It is an additional cost of acquiring a structural asset. And it is irrelevant that the taxpayer was unaware of the need for repair at the time of acquisition of the asset. If the expense is an initial repair expense it may not be dissected or apportioned so as to allow a deduction of some part of the expense that may be said to make good deterioration arising from the use of the asset after acquisition. The arguments against dissection or apportionment made in relation to the entirety and improvement principles are again applicable. Section 53(3), considered further in [10.31] below has no application. The Commissioner has a power to apportion only where the whole amount could be deductible under s. 53(1).

10.23 A repair undertaken before it is due, in the sense adopted in [10.21], will not for this reason be denied deduction. There is a principle, expressed by Windeyer J. in W. Thomas & Co. (1965) 115 C.L.R. 58 in the metaphor of “a stitch in time”, which would allow a deduction if it was reasonable to undertake the repair. Repainting is perhaps the most obvious illustration of a repair that may be undertaken “early” without an effect on deductibility. In W. Thomas & Co., Windeyer J. held that a taxpayer who repaints shortly after acquiring property does not make full and true disclosure simply by disclosing the times of acquisition and repainting. The Commissioner is entitled to know that the repainting was not an early repair. The repainting will not however be deductible unless it is undertaken to restore deterioration. Repainting to change the colour of a building found unattractive will not be a repair.

10.24 In some circumstances a repair undertaken in some connection with the disposition of the item repaired will not be deductible: it will be treated as a cost of disposition of the item and denied deduction, just as a repair which was a cost of acquiring the item may have been denied deduction. There is a question of the kind of connection with the disposition that will
make the repair what may be called a “final” repair. The fact that the person who acquires property “due” for repair will not be entitled to a deduction when he carries out what are “initial” repairs, may suggest that a taxpayer who proposes to dispose of property due for repairs should effect repairs before he disposes of it. If he acts to repair before he has entered into any agreement to dispose of the property, though contemplating the disposition, he will presumably be entitled to a deduction. If, however, he enters into a contract under which he agrees to carry out repairs before completion, the costs of those repairs may well be denied deduction. Foxwood (Tolga) Pty Ltd (1981) 147 C.L.R. 278 has a bearing. A payment to the buyer of a business, by way of an adjustment to the purchase price, to provide the money from which the buyer might make payments for long service leave to employees who had accrued that leave at the time the business was acquired, was treated as a cost of disposing of the business. In Peyton (1963) 109 C.L.R. 315 a deduction was denied of an amount paid by a lessee to a lessor in lieu of effecting repairs the lessee was obliged by the lease to carry out. The payment was treated as a cost of assigning the lease. A deduction is now available in circumstances of Peyton following the enactment of s. 53AA, discussed in [10.125][10.127] below. But the cases recognise a principle that an expense may be denied deduction, whatever treatment it might otherwise be given, if it is a cost of disposing of property that is not a revenue asset.

10.25 There is a reference in the judgment of Windeyer J. in W. Thomas & Co. to a repair as a restoration of deterioration due to “wear and tear”. Which may suggest that a repair to restore damage caused by some extraordinary event—a fire or malicious damage by another—is not deductible. At least in the malicious damage situation, it may be thought that the expense does not have a working character. The discussion of W. Nevill & Co. Ltd (1937) 56 C.L.R. 290 in [6.17]–[6.21] above is relevant. Deductibility may be supported on the ground that the event is of a class which is a recognised incident of the holding of property.

10.26 There is some room for an argument that a repair is “abnormal” and not deductible—in effect that it should be treated as a cost of acquiring the item repaired—if the need for repair is the result of some inherent defect in the item at the time of acquisition. A building that was erected on inadequate foundations may be in frequent need of repairs caused by movement of the structure. There is some room for an argument that a repair made necessary by an inherent defect in the item is a cost of the item and not deductible. Any such principle would pose a question of the meaning to be given to the notion of inherent defect, and this in itself may make the principle unattractive. A building may be erected with wooden
floors too close to the ground, and thus subject to rotting. It may be asked if this is an inherent defect so that the cost of replacing the flooring is not a deductible repair. A repair directed to removal of the defect, for example by the replacement of the wooden floors with concrete floors, will not doubt be denied deduction as an improvement. But a simple replacement of the wooden floors, albeit done the more frequently because of the defect in the building, should not be denied deduction.

Contemporaneity and relevance

10.27 A principle of contemporaneity as an aspect of the interpretation of s. 51(1) was explained in [5.37]–[5.48] above and as an explanation of the decision in Ilbery 81 A.T.C. 4234; 81 A.T.C. 4661 in [6.120] above. The principle, is, it seems, distinct from the requirement of relevance, though A.G.C. (Advances) Ltd (1975) 132 C.L.R. 175 may indicate that the High Court is ready to restate the principle in a way that will reduce its significance, so that contemporaneity becomes no more than an indication of relevance.

10.28 Whether a principle of contemporaneity has any place in the operation of s. 53 must be answered from the terms of s. 53(1) and s. 53(2). Section 53(3), which gives the Commissioner a power to apportion in some circumstances, applies only to expenditure otherwise deductible under s. 53 (1). Section 53(1) is equivocal. On one interpretation it expresses a principle of contemporaneity that is the same as that applicable under s. 51 (1): an expense which is otherwise for repairs is deductible if it is contemporaneous with the holding, occupation or use of property for the purpose of producing assessable income, or with the holding, occupation or use of property in carrying on a business for the purpose of producing assessable income. Contemporaneity would be judged by reference to the time the expenditure was “incurred”, which would leave some room for planning by a taxpayer, and would be a hazard for the unwary. If the taxpayer accounts for the expenditure on a cash basis a deduction may be available for expenditure for repairs, effected before the property is let but paid for after the commencement of letting, and a deduction may be denied for expenditure for repairs effected while property is let but paid for after the letting has ceased. Planning so as to make payment after the letting had commenced might be defeated by a principle suggested by the “initial” repairs principle—an expense for repairs prior to the commencement of the letting is an expense to prepare the property for income derivation. Indeed if there is no such principle, the “initial” repairs principle appears not as fundamental doctrine but as a rogue intruder into this part of the law. And
the Commissioner may have power, under s. 53(3), to defeat the planning. He may have power to apportion the expenditure and deny a deduction of such part of it as relates to the use of the property prior to the commencement of the letting.

10.29 None the less the occasions of the hazard will be many. The taxpayer who effects repairs between tenancies will be denied deduction, unless he ensures that the expenses are incurred after the new tenancy commences. It is true that the contemporaneity principle may produce similar hazards in the operation of s. 51(1). Which may indicate that, as a distinct principle, it should be abandoned. There will then be no need to resort to a notion of business “suspension”, as distinct from cessation, as was done in A.G.C. (Advances), to save the deductibility of an expense. In the case of s. 53, there is no obvious presence of a principle of relevance waiting to judge the significance of a want of contemporaneity. And the “initial” repairs doctrine may be thought to preclude a principle of relevance: it is not significant that the need for repair is due in part to earlier holding, occupation or use of property other than for the purpose of producing assessable income, or unless that holding, occupation or use had brought about a situation in which repairs were “due”.

10.30 While there is no obvious presence of a principle of relevance, a view of s. 53 that it does no more than confirm s. 51(1)—that it is, in a phrase used by Sir Owen Dixon, “epexegetical” (Parke Davis & Co. (1959) 101 C.L.R. 521 at 527)—would justify drawing a principle of relevance from s. 51(1). It is then possible to give s. 53 an operation that is parallel with the operation of s. 51(1) in regard to payments of interest on money invested in assets, or payments of insurance, rates and taxes on property. The operation of s. 51(1) in regard to these expenses is to allow a deduction to the extent to which the function of the expense is to maintain property in its use for the purpose of income derivation. A parallel operation of s. 53(1) would be to allow deduction of expenses for repairs to the extent to which their function is to maintain property in its use for the purpose of income derivation. There will be problems, however, in making an apportionment where the need for repairs has arisen out of use of the property in a prior year of income. The operation of the principle of apportionment so far as s. 51(1) is concerned is, it seems, to apportion by reference to the amount of time during the year of income when the property was used in a process of income derivation, which will be generally, though not always, appropriate. In any case, s. 53(1) does not include the words “to the extent to which” that appear in s. 51(1). The consequence may be that s. 53(1) does not admit of an apportionment—an amount is wholly relevant or not relevant at all. There will remain,
however, a question whether an expense can be relevant even though there is no holding, occupation or use of the property during the year of income for the purpose of producing assessable income. The property may have been held, occupied or used for that purpose during a previous year of income. Again s. 53(1) is equivocal. The words “in the year of income” control “incurred”. They may not control “held, occupied or used”.

10.31 Section 53(3) gives the Commissioner an express power of apportionment so as to deny the deduction of some part of expenditure that would be an allowable deduction under s. 53(1). The power given is to allow a deduction of only so much of the deduction otherwise allowable “as, in the opinion of the Commissioner, is reasonable in the circumstances”. It might be argued that the express provision precludes any apportionment in the operation of s. 53(1): it could not have been intended to add a power to apportion where there could already have been an apportionment in the operation of s. 53(1). The argument has force although, it should be noted, s. 53(3) is an addition to the Assessment Act in 1984 and ought not to control the meaning of words in the section as originally enacted.

10.32 If one assumes that subs. (3) is the only provision under which there can be an apportionment, there will remain questions as to the scope of its operation. The section gives the Commissioner the power to apportion where the property was “held, occupied or used by the taxpayer only partly for the purpose of producing assessable income, or only partly in carrying on a business for that purpose”. Those words admit of one or more of the following meanings:

(i) only part of the relevant property has been held, occupied or used for the purpose of producing assessable income in any period prior to the repair;
(ii) relevant property has been held, occupied or used for the purpose of producing assessable income for part only of any period prior to the repair; and
(iii) relevant property has been held, occupied, or used during any period prior to the repair for purposes that are only in part purposes of producing assessable income.

The first meaning would bring s. 53(3) into operation where, for example, the roof is repaired of a building that includes a shop and a residence. The second would bring s. 53(3) into operation where a house has been let for only part of any period prior to the repair. The third meaning would bring s. 53(3) into operation where, for example, a house has been the subject of a charity letting, involving purposes to derive income and to be charitable. Circumstances may be within two or more of these meanings. Thus a house may be let in a charity letting for only part of any period prior to the repair. Which may explain why s. 53(3) does not
dictate any formula by which the apportionment is to be made.

10.33 In all instances the above formulations of meaning refer to use in any period prior to the repair. Which is to assume an interpretation of s. 53(1) that does not apply the words “in the year of income” to the holding, occupation or use of the relevant property. If those words are to be applied to the holding, occupation or use, the circumstances in which the Commissioner has power will be narrower, but there will remain a question of whether he can, in the proper exercise of his power, take into consideration the fact that the property was not held, occupied or used for the purpose of producing income in some period prior to the year of income, and the need for repairs has arisen to a degree out of the holding, occupation or use during that period. And there will be a question whether he can take into consideration any holding, occupation or use subsequent to the time of the repair.

The meaning of “use” in section 53

10.34 Attention was directed in [6.156] above to a possible interpretation of the word “use” in s. 53, such that a taxpayer who lets property at a non-commercial rental to a relative or other recipient of his charity, must none the less be regarded as using the property exclusively in the derivation of income. Such an interpretation of the word “use” in s. 67 was adopted by the Federal Court in *Ure* (1981) 81 A.T.C. 4100. The interpretation was the subject of comment in [6.115]–[6.116] above and again in [6.152] above. The view expressed in those paragraphs would reject this interpretation of the word. Expenses of repairs to property which is the subject of a charity letting have only in part a function to maintain property in its use for the purpose of income derivation. The consequences for the operation of s. 53 raise issues already explored.

Section 64: expenditure by way of collecting assessable income

10.35 Section 64 provides that expenditure incurred by the taxpayer by way of commission for collecting his assessable income is an allowable deduction. The section simply confirms the operation of s. 51(1). It is the subject of some comment in [6.284] above.

Section 64A: legal expenses

10.36 Some legal expenses that are not working expenses are expressly made deductible by ss 67, 67A, 68 and 68A. They are considered in [10.217]–[10.232] below. Section 64A is intended to allow deduction of
other legal expenses that are not deductible under s. 51(1). The structure of the provision is curious. It confirms the operation of s. 51(1) in regard to the legal expenses (defined in s. 64A(1)) of a business, and seeks to extend the operation of s. 51(1), subject to a money limit of $50, by adopting a form of words which omits the references to “outgoings of capital or of a capital private or domestic nature” that appear in s. 51(1). The operative provision is s. 64A(2).

10.37 On the view taken in this Volume of the structure of s. 51(1), s. 64A can have no operation beyond the partial confirmation of s. 51(1). The omission of the so-called exception of capital outgoings has no effect in increasing the range of deductibility, if an expense that is a capital outgoing can never be embraced by the words “incurred in the carrying on of a business for the purpose of gaining or producing assessable income”.

Section 72: rates and taxes

10.38 Some of the history of s. 72 and problems of the interpretation were considered in [6.149]–[6.155] above. The provision in s. 72(2) in regard to the assessability of refunds was considered in [2.549] and [4.223]–[4.226] above.

10.39 The correlation between the operation of s. 51(1) and the operation of s. 72 raises questions which are parallel with questions already raised in [10.8]–[10.9] and [10.27]–[10.33] above in regard to repairs. Those questions concern the possibility that s. 72 is a code, the need for contemporaneity, the formulation of any principle of relevance, the need for apportionment and the operation of the express power to apportion given by s. 72(1c). There is however one important difference: subss (1) and (1B) of s. 72 require, for deductibility, both that the amount should be paid in the year of income and that the relevant property should be used during the year of income for the purpose of gaining or producing income. In the result, the question raised in relation to s. 53 whether a deduction may be allowed where the property was held, occupied or used for the purposes of producing assessable income in a period prior to the year of income, but not in the year of income, has no parallel in relation to s. 72. But there will be parallel questions as to the operation of the power to apportion given to the Commissioner by s. 72(1C).

10.40 There is a curious aspect of s. 72 which may be noted. It would appear that it has a potential application to allow a deduction notwithstanding that the income from the use of the relevant property is exempt income. Subsections (1), (1B) and (1C) of s. 72 omit the word “assessable” before the word “income”.
Provisions Allowing Deductions Beyond the Operation of Section 51(1), by Allowing Deductions of Expenses not yet Incurred under Section 51(1) or which are not Relevant to the Derivation of Income

Section 51A: deduction in respect of a living away from home allowance

10.41 The deduction for which s. 51A provides is intended to be additional to and distinct from any deduction that may be available to the taxpayer under s. 51(1).

10.42 The amount of the deduction is limited in various ways by subs. (2) of the section. All the limits are related to the amount of a “living-away-from-home” allowance which is included in the assessable income of a taxpayer who is an employee. Where the allowance is granted under the terms of any law or of any award order or determination of an industrial tribunal, or of an industrial agreement, the deduction is a sum calculated as provided in the subsection. In other circumstances the deduction is limited by a discretion given to the Commissioner to determine how much of the allowance is reasonable: the deduction is limited to the amount of the allowance that the Commissioner considers reasonable (less $2 per week).

10.43 If the allowance is not assessable income of the employee, no deduction is available under s. 51A. The definition of “living away from home allowance” in s. 51A(3) is so much of an allowance “as the Commissioner is satisfied is in the nature of compensation to the employee for the additional expenses (not being expenses which are allowable as a deduction under s. 51) incurred by him or which would be incurred by him if the allowance or benefit were not received, through having to live away from his usual place of abode in order to perform his duties as an employee”.

10.44 The inter-relation of s. 51A and general principles of income and deductibility is not easily discerned. It is arguable that an allowance in the nature of compensation for the expenses specified in the definition is not income. Proposition 7 discussed in [2.113]ff. above is relevant. There is authority in Hochstrasser v. Mayes [1960] A.C. 376 that an allowance to meet expenses incurred by an employee in serving the interests of his employer, is not income. The expenses in these circumstances are not deductible by the employee. If expenses are deductible by the employee, an allowance in the nature of compensation for them is not a “living away from home allowance”, and s. 51A can have no operation.

10.45 The reply to the argument in terms of Hochstrasser v. Mayes would refer to Lunney (1958) 100 C.L.R. 478 and assert that the expenses of
living away from home are not expenses that are incurred in the interests of
the employer: they are incurred as a consequence of the employee's
decision to maintain his usual abode in a place remote from his place of
work. The allowance is akin to an allowance received by an employee to
meet his expenses of travel between home and his place of work. The
allowance is income and the expenses are not deductible. In truth, his
expenses of living away from his usual place of abode in order to perform
his duties as an employee are, in function, somewhere between the
expenses of living at home, an allowance for which is not within the
contribution to capital principle, and the expenses of moving one's home so
as to be near to a new place where the employee is now required to work,
an allowance for which is within the contribution to capital principle.

10.46 The expenses are the more likely to attract the contribution to capital
principle if the employee is required to work away from his usual place of
abode only for a limited period. In such circumstances it is more easily
asserted that the expenses are a consequence of the location of his place of
work, rather than a consequence of the location of his place of abode.

10.47 If he has been required to move permanently to a new place of work,
the allowance is less likely to attract the contribution to capital principle,
and s. 51A will have room to operate. There is then the prospect that the
Commissioner will at some stage conclude that the allowance is not a
living away from home allowance, because it is not compensation to the
employee for additional expenses incurred by him through having to live
away from his usual place of abode in order to perform his duties. The
Commissioner may say that after a lapse of time within which the taxpayer
might have shifted his usual place of abode the expenses are not the result
of having to live away from his usual place of abode in order to perform
his duties. They are the result of his decision not to move his usual
place of abode. At least it may be open to the Commissioner to take such a view
where it would be reasonable to expect the taxpayer to move his usual
place of abode. The fact that the new place of work is in some remote area
will be relevant.

10.48 The discussion so far has been concerned with a taxpayer who is
required by his employer to change his place of work. Section 51A may
operate in circumstances where the taxpayer enters on an employment for a
new employer at a place of work remote from his usual place of abode. It
will be relevant to a conclusion by the Commissioner that the allowance is
a living away from home allowance that the new employment is for a
limited period or that the place of work is in some remote area.

10.49 The section can only operate if the taxpayer has a usual place of
abode and lives away from it in order to perform his duties as an employee.
If he in fact moves his usual place of abode to the location of his new place of work, there is no room for the operation of the section.

Section 63: bad debts

10.50 Some reference was made in [6.310]–[6.321] above to the operation of s. 63, and some comparisons were drawn with the operation of s. 51(1) in relation to losses arising in regard to receivables.

A comparison of section 63 and section 51(1)

10.51 The specific deduction for the “write-off” of a bad debt under s. 63 differs from the deduction that may be available in regard to a receivable under s. 51(1) in a number of respects. The most significant difference is that s. 63 may allow a deduction though no expense has yet been incurred under s. 51(1). It is enough to warrant a deduction under s. 63 that a “bad debt” has been “written off as such”. A deduction under s. 51(1) for a loss in regard to a receivable must await the realisation of the receivable. Realisation, it was asserted in [6.318]–[6.319] above, occurs when a receivable is disposed of, when something is taken in satisfaction of the receivable, when the receivable is released or when the receivable becomes irrecoverable because the debtor is bankrupt and without assets, or becomes irrecoverable in a commercial sense because the debtor cannot be found or is without assets.

10.52 The event that gives rise to deduction under s. 63 is a “write-off”, an accounting entry directed not to the taxpayer's receivables in general—a provision for bad debts is not a write-off—but to a specific receivable considered to be bad.

10.53 A “write-off”, as those words have been interpreted in their use in s. 63, more especially in Point (1970) 119 C.L.R. 453, would not be a realisation of a receivable so as to give rise to a loss deduction under s. 51 (1). The use of the words “write-off” in s. 63A to identify the event which gives rise to deductibility under s. 63 and s. 51(1) was the subject of some comment in [6.318] above. The use of a single phrase may have its origin in what may appear to be the assumption in a recommendation of the Ligertwood Committee (Report of the Commonwealth Committee of Taxation, June 1961) that the words “and no other bad debts” which appeared in s. 63 prior to 1963 should be deleted (Report, para. 146). The recommendation follows an observation by the Committee that:

“145. We consider that any loss, except one of a capital, private or domestic nature, which results from business operations should be allowable in accordance with the tests contained in s. 51. We take the view that a loss in respect of an
advance made in the course of carrying on a business should fall for consideration as an allowable deduction under s. 51 of the Act, but that course is at present not available because of the words ‘and no other bad debts’ contained in s. 63.’

The assumption in that observation is that “written-off as such” is the moment of incurring a loss in respect of a receivable under s. 51(1), and that s. 63 by the words “and no other bad debts” had limited the operation of s. 51(1). The assumption receives no support in judicial decision, and it would be at odds with the fundamental principle that the Assessment Act, save where specific provision is made, is concerned with realised losses and gains.

10.54 The deletion of the words “and no other bad debts” from s. 63 did not, in fact, have any effect on the operation of s. 63 or s. 51(1). Section 63, then as now, extended the operation of s. 51(1) by allowing a taxpayer to anticipate the loss deduction under s. 51(1) by the earlier write off of a debt. At no stage did it limit the operation of s. 51(1). It would be an odd construction of the section that it should be held to be a code in regard to the deduction of losses in respect of receivables. There has been no hint in the authorities in regard to exchange losses that the only available deduction in regard to an exchange loss in respect of a receivable is for a write-off reflecting the anticipated loss the taxpayer is likely to suffer, if a movement in the exchange rate that has occurred is sustained until there is a receipt of the receivable. It is no doubt arguable that any s. 63 code relates only to “bad debts”, and that a receivable that has fallen in value because of a variation in exchange rates is not in this respect a “bad debt”. But the search for the scope of a s. 63 code was always unnecessary. The reference to “no other bad debts” was intended to emphasise that s. 63, in its operation to allow the advancement of deductibility of an expense, was confined to the kinds of receivables specifically mentioned. It remains so confined after the deletion of the words.

10.55 The assumption in the Ligertwood Committee recommendation may reflect another assumption about s. 51(1)—that the section is an aspect of receipts and outgoing accounting and that it does not provide for the deduction of a “loss” that is a balance of cost and proceeds. Such an assumption has now been rejected in *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347, and more directly in relation to bad debt losses, in *A.G.C. (Advances) Ltd* (1975) 132 C.L.R. 175.

10.56 The effect on general principles of the references to writing-off in s. 63A must await judicial decision. It would be strange indeed if it were taken to enact the misapprehension on which the recommendation of the Ligertwood Committee proceeded.

10.57 Section 63 is applicable only to the kinds of debts that are listed in the section: (a) “[debts which] . . . have been brought to account by the
taxpayer as assessable income of any year”, and (b) “[debts which] . . . are in respect of money lent in the ordinary course of the business of the lending of money by a taxpayer who carries on that business.” The latter will include a debt for interest on money lent in the ordinary course of such a business: National Commercial Banking Corp. of Australia (1983) 83 A.T.C. 4715. The receivables to which s. 51(1) has potential application are in some respects wider: a comparison in this respect is made in [6.315]–[6.316] above. Section 63 will extend to a receivable in respect of the supply of trading stock because the method of the Act in s. 28 and s. 51 (2) is to make the proceeds of supply of trading stock assessable income. Section 63 will not apply to a receivable in respect of the supply of property which is a revenue asset but is not trading stock. Section 51(1) may apply to such a receivable. Section 63 will extend only to some receivables arising from lending. Section 51(1) will apply to any lending on revenue account, which may include a loan to an employee of the taxpayer, or a loan to the taxpayer's supplier or to an outlet for the taxpayer's production. In some respects the receivables to which s. 63 has an application are wider than those that may be the subject of a loss deduction under s. 51(1). A debt which has been brought to account as assessable income is not necessarily a revenue asset in respect of which there may be a loss deduction. It was explained in [6.310] above that accommodation granted by a seller or supplier of services in allowing the buyer a long term in which to pay may be an accommodation granted on capital account. The receivable will not be a revenue asset. The instance was given of a parent company that provides finance for its subsidiary in this manner. The parent has invested in the subsidiary. Paragraph (b) of s. 63, as interpreted in National Commercial Banking Corp. of Australia, will include a debt for interest receivable on money lent in the ordinary course of business, even though that interest is to be accounted for on a cash basis. In this instance s. 63 may be thought to have a rogue operation. Section 51 (1) would not allow a loss deduction in these circumstances.

10.58 Section 63 will probably extend to allow the deduction of a bad debt write-off even though the writing off is done after the business activity in which the receivable arose has ceased. It is perhaps arguable that the write-off referred to in s. 63 must be an entry in the books of a business that is presently carried on, but such a construction is unlikely. Section 51(1) is limited in its operation by the principle requiring that the incurring of a loss must be contemporaneous with the process of deriving income.

10.59 Section 63, it is assumed, contemplates a partial write-off of a debt. It may be written off to the extent that, in the bona fide judgment of the taxpayer, it will not realise the amount at which it was brought to account:
G. E. Crane Sales Pty Ltd (1971) 126 C.L.R. 177 at 192, 196-7, per Walsh and Gibbs JJ. There may thus be several “write-offs” in respect of the same debt, each write-off involving a revised estimate of the extent to which the debt is bad. A loss deduction under s. 51(1) in respect of a receivable arises finally on one event. The amount of the loss is a matter of fact, not primarily one of estimate, though a value may need to be given to what is received by the taxpayer on the realisation in determining the amount of the loss.

10.60 A s. 63 deduction is available only in respect of a “bad debt”. The suggestion is made in [6.317] above that the phrase “bad debt” may limit the operation of the section to circumstances where the debtor is unable to pay the full amount of the debt. It follows that a debt in a foreign currency is not a bad debt simply because a change in the exchange rate has brought about the consequence that payment in full of the debt will, in Australian currency, yield an amount less than the amount of Australian currency at which the debt was brought to account. Section 51(1) is available whatever the reason the receivable fails to realise its cost.

10.61 Point (1970) 119 C.L.R. 453 is authority that a debt which ceases to exist as a debt owed to the taxpayer cannot thereafter be the subject of a write-off for which s. 63 may allow a deduction. If debts are assigned by a taxpayer company to a receiver and manager who is not simply an agent to collect the debts, s. 63 is no longer available to the taxpayer: G. E. Crane Sales Pty Ltd, Betro Harrison Constructions Pty Ltd (1978) 78 A.T.C. 4431. The assignment, again on the authority of Point, is not itself a “write-off”. It follows that if the taxpayer has ceased at the time of the assignment to carry on the business whence the receivable arose, s. 51(1) and s. 63 deductions are both precluded. Point, it is true, concerned a release under a scheme of arrangement, but what is true of a release should equally be true of an assignment.

10.62 Where s. 63 applies, the amount of the deduction is the amount written-off. Where a deduction is claimed under s. 51(1), the deduction is the amount of the loss and, in calculating that amount, it is necessary to bring the account any proceeds of realisation. The difficulties that may arise in determining the amount of the loss where realisation involves a release under a scheme of arrangement, as in Point, or where the realisation is an assignment to a receiver and manager, as in A.G.C. (Advances) Ltd (1975) 132 C.L.R. 175 are the subject of some comment in [6.321] above. Section 63 is not immune from those difficulties. Subsection (3) provides that where a taxpayer “receives an amount in respect of a debt for which a deduction has been allowed to him under this or the previous Act, his assessable income shall include that amount.” Where a debt that has been
the subject of a write-off is subsequently released under a scheme of arrangement or is assigned to another, the proceeds of the release or assignment must then be brought to account. The language of s. 63(3), it might be noted, seems adapted only to a situation where the “write-off” was of the whole amount of the debt, which may suggest that a partial write-off is not contemplated by the section, despite the judicial assumption that it is.

Section 63 and section 51(1) in relation to the treatment of the book debts of a business that is sold

10.63 The operation of the contemporaneity principle in determining deductibility under s. 51, and the fact that the principle does not operate in relation to s. 63, suggest that book debts for goods or services supplied should not be assigned to the buyer of a business. The seller should retain them. If he retains the debts the seller will be entitled to write-off debts that become bad. The buyer who has taken an assignment will not be able to write-off the debts that become bad, because they will not have been brought to account as assessable income of the buyer. In *G. E. Crane Sales Pty Ltd* (1971) 126 C.L.R. 177, s. 63 was held not to be available to the buyer of book debts because the write-offs occurred after further assignment to a receiver and manager, so that they were no longer debts owed to the buyer. The court reserved its opinion on the question whether the debts could be said to have been brought to account as assessable income of the buyer.

10.64 If the buyer of a business does acquire the book debts he may be entitled to deductions for any losses on the realisation of the debts, provided he continues to carry on the business. This is to assume that the book debts so acquired are revenue assets of the business carried on by the buyer, an assumption that may not be sound. The seller of a business who disposes of the book debts may be entitled to deductions for losses realised on the disposition. This is however to assume that the realisation of revenue assets in the act of disposing of a business may generate deductible losses under s. 51(1), another assumption that may not be sound. It will be apparent that the retention of book debts, by the seller of a business, is the more appropriate action.

“Write-off” and section 51(1) deduction

10.65 In *A.G.C. (Advances) Ltd* (1975) 132 C.L.R. 175 the debts owing to the taxpayer were owed in respect of the principal sums under hire purchase transactions. They had not been brought to account as assessable
income, and s. 63 had no application. The High Court allowed deductions under s. 51(1), for what were described by counsel as “write-offs”. The outcome is more than a little confusing. There was no argument on the question of when the losses occurred. All members of the High Court made observations which at least leave room for the point of view taken in [10.58] above that writing off is not the event which gives rise to a loss deduction under s. 51(1). Barwick C.J. (at 185) referred to the “writing off of the debts, which for this purpose seems to have been regarded by counsel as the time at which the loss was incurred”. Gibbs J. said: “it may be assumed that the losses were incurred when the amounts were written off . . . ” (at 192). Mason J. said: “That the relevant amounts were losses incurred at the time when they were written off is not in question . . . ” (at 195). It is a demonstration of the inadequacies of analysis and doctrine that the assumption of s. 63A is found in the agreement between counsel in A.G.C. (Advances), and that the taxpayer had to be saved from being defeated by the contemporaneity principle by a conclusion that the business had not ceased, but was suspended.

The operation of section 51(1) and section 63 where a debt or other property is taken in respect of a debt

10.66 It may assist an understanding of the interplay of s. 51(1) and s. 63 to consider the effect of those sections at different stages of a series of events that involve a taxpayer on an accruals basis of tax accounting, who, being entitled to $100,000 for services supplied to a company in the carrying on of his business, accepts a debenture for $100,000 issued by the company, and subsequently sells that debenture for $50,000.

10.67 If it be assumed that no action was taken by the taxpayer at any time explicitly to write-off any part of the original debt or the debenture debt, his right to any deduction must rest on the operation of s. 51(1). Neither the acceptance of the debenture nor the sale of the debenture is a write-off that could attract s. 63.

10.68 The acceptance of the debenture could be a realisation of the original debt—a revenue asset—and give rise to a loss deduction. The amount of the loss would be the difference between the amount of the original debt and the value of the debenture, a value that will reflect the rate of interest, the term of the debt and the financial responsibility of the debtor. Whether or not the acceptance of the debenture is a realisation of the original debt may turn on whether the debenture was taken by way of security for the original debt or in satisfaction of the original debt. If it was taken by way of security there would as yet have been no realisation of the original debt,
though there would be a realisation if the taxpayer sells the debenture in the exercise of his power of sale. If the proceeds are less than the original debt, and the balance is commercially irrecoverable, there will be a deductible loss to the extent of the balance.

10.69 The acceptance of the debenture in satisfaction of the original debt is not necessarily a realisation of the debt. A number of authorities, some concerned with the question whether a cash basis taxpayer has received a payment of interest on a debt when he takes a new promise by the debtor to pay, may suggest that a taxpayer who has no choice between receiving payment in cash—the being no offer of cash—and taking the debenture, has not realised the original debt: *Parker v. Chapman* (1928) 13 T.C. 677; *C. of T. (Q.) v. Union Trustee Co.* [1931] A.C. 256; *Cross v. London & Provincial Trust Ltd* [1938] 1 K.B. 792; *Griffin Shave & Co. Pty Ltd v. C. of T. (N.S.W.)* (1933) 2 A.T.D. 305; *Calders Ltd v. I.R.C.* (1944) 26 T.C. 213. Realisation of the original debt is, presumably, to be treated as delayed until the debenture debt is realised. At the time there will be a loss deduction of the difference between the original debt and the proceeds of realisation of the debenture debt. A disposition to treat a new debt taken in satisfaction of an original debt as not being a receipt of the original debt may be appropriate when the issue is whether the taxpayer has a receipt that will be income derived by him. A different view might be thought appropriate when the issue is whether the taxpayer has a s. 51(1) loss deduction. However, though involving a loss on discharge of a liability, *Caltex Ltd* (1960) 106 C.L.R. 205 may indicate that there is no realisation of a loss. The case involved the acknowledgement of a new debt to a new party. But it was not held to be a discharge of the original liability so as to generate an exchange loss deduction under s. 51(1).

10.70 *Caltex Ltd* left open a question whether the new debt acknowledged involved a liability on revenue account, so that a discharge of the new debt might generate an exchange loss deduction. Coherent principle would demand that the new debt be so regarded. And if a taxpayer has taken a new debt in satisfaction of an original debt owed to him, and the taking of the new debt does not involve a realisation of the old, the new debt should be treated as standing in the shoes of the old so that a loss deduction in respect of the old may arise when the new debt is realised.

10.71 Where a taxpayer takes not a new debt but some other kind of property in satisfaction of an original debt, there would appear to be no room for a view that the taking of the property is not a realisation of the original debt. The fact that a cash payment is not offered to him will be relevant to the question of the character in his hands of the property taken, but it does not prevent a conclusion that there has been a realisation of the
original debt.

10.72 It is possible to conclude that the new item of property, though taken in a realisation of the original debt has, none the less, the revenue character of the original debt, so that a loss on the realisation of the new item will be deductible under s. 51(1). The new item of property may have the character of a revenue asset because it was acquired in the process of obtaining satisfaction of the original debt. Mr O'Neill in a Board case ((1970) 70 A.T.C. 273 at 277) said of a loss on the realisation of the new item of property:

“The loss that was in fact sustained was incurred [by the taxpayer] in an operation of business concerned with the regular inflow of revenue—the collection or conversion to cash of debts owed to it for goods supplied in the ordinary course of its business . . . ”

The cost of the new item of property will be the amount brought into the calculation of any gain or loss on the realisation of the original debt. The reference to gain is intended to emphasise that the realisation of the original debt, being by hypothesis a revenue asset, may generate a gain if the new item of property taken in satisfaction is of greater value than the amount of the original debt. So too, if the new item of property is held to be a revenue asset, the taxpayer will be at risk that the realisation of that item will produce a gain that is income.

10.73 The new item of property will have a revenue character if it has been acquired in the process of obtaining satisfaction of the original debt. It will have been so acquired if the taxpayer was not offered a choice between payment in full in cash and the new item of property. If he has been offered cash, but responded to an invitation to invest the money in some item of property—it might be shares in the debtor company—the shares do not attract the character of the original debt. They are not acquired in the process of obtaining satisfaction of the original debt. They are an investment of the proceeds of the original debt. If the shares are revenue assets in the hands of the taxpayer, it will be because they are assets of a business of dealing in shares, or they are held as assets of a business of investing of the kind in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106 or in the banking and life insurance cases.

10.74 The discussion so far has been limited to the effect of s. 51(1) at different stages of the series of events. The taxpayer might have written off the original debt in whole or in part and become entitled to a deduction under s. 63 before he accepted the debenture. If the taking of the debenture is a realisation of the original debt, there will be an operation of s. 63(3) on the taking of the debenture. If the value of the debenture exceeds the written down amount of the original debt, there is “an amount received in respect of the debt” which is assessable income of the taxpayer. Section 63
(3), it was noted above, is not easily applied in a partial write-off situation, but if it is held that s. 63(1) does apply to a partial write-off, the amount of income under s. 63(3) must be confined to the excess of the value of the debenture over the written down amount of the original debt. The value of the debenture is an amount received in respect of the debt because of the operation of s. 21, which deems the money value of the debenture to have been received.

10.75 The taking of the debenture in realisation of the original debt will be an occasion of a s. 51(1) loss deduction. In computing that loss, s. 82(2) will deny a subtraction of the deduction allowed under s. 63, save so far as that deduction has been reversed by the operation of s. 63(3). If it has been reversed, a sensible operation for s. 82 requires that it should not be treated in the operation of s. 82(2) as a deduction allowed. If the debenture has a value greater than the original debt, there is a prospect that both s. 63(3) and the general principle applicable to the realisation of a revenue asset will bring in a profit. The profit will not be twice included in income: an item that is income under two provisions of the Act is income once only.

10.76 If the debenture is taken in satisfaction of the original debt but this is not held to be a realisation, there will be an operation of s. 63(3) on the receipt of the debenture, but no operation of s. 51(1). There will be an operation of s. 63(3), because a debenture received in satisfaction of the original debt is, by force of s. 21, deemed to be an amount received in payment of the original debt. When the debenture is realised, there will be a need to correlate the operation of s. 51(1) with the earlier operation of s. 63. If s. 63(3) has had the effect of bringing in as income a profit on the receipt of the debenture, it will be necessary to ensure that any profit on the realisation of the debenture—prima facie the surplus of the amount received on realisation of the debenture over the amount of the original debt—that has already been treated as income under s. 63(3), is not again treated as income. This objective will be achieved by allowing the profit treated as income under s. 63(3) as a cost in computing any profit that is income on the realisation of the debenture. The amount of the debt written off under s. 63 will not be subtractable in calculating the profit on realisation of the debenture. This follows from s. 82.

10.77 Any write-off of the original debt subsequent to the receipt of the debenture in satisfaction of the original debt will not have any tax consequences. It comes too late—Point (1970) 119 C.L.R. 453—and no problems of correlation with s. 51(1) can arise.

The effect of sections 63A, 63B, 63C and 80F
10.78 The Assessment Act was amended in 1973 to introduce provisions qualifying deductibility of losses under s. 63 and s. 51(1) by a company, where there is a break in continuity of ownership of the company between the time of the debt arising and the time when the debt is written off, or the time when a loss in relation to the debt is realised. The effect is to limit the deductibility which would otherwise arise under s. 63. The effect is also to limit the availability of a deduction that would otherwise be allowable under s. 51(1).

10.79 The pattern of the provisions in ss 63A, 63B and 63C follows the pattern of provisions in ss 80A, 80B, 80DA and 80E which deny loss carry forward by a company where there has been a break in continuity of ownership of the company. The latter provisions are considered in [10.375]–[10.420] below.

10.80 Sections 63A, 63B and 63C were introduced in order to defeat a practice designed to circumvent the operations of predecessors of the company loss carry forward provisions. Shares in a company with potential bad debts losses not yet the subject of write-off and not yet realised, would be sold. The bad debt losses would then be incurred. If these losses created a loss to be carried forward, ss 80Aff. could not defeat the carry forward of the loss because the break in continuity of ownership would have occurred before the loss was incurred.

10.81 The effect of s. 63A and s. 63B is that a bad debt loss incurred under s. 63 or s. 51(1) is not deductible unless there is a continuity of ownership of the company subsisting at all times in the year in which the debt arose and in the year in which the loss was incurred. There is a qualification in s. 63C, whereby a continuity of carrying on the same business subsisting at the time immediately before the change in ownership and in the year in which the bad debt loss is incurred will exclude the operation of s. 63A and s. 63B.

10.82 Section 80F supplements the provisions of s. 80Aff. If the deductibility of a bad debt loss is otherwise preserved by the operation of s. 63C, and a loss to be carried forward results from the deduction of that loss, the carry forward of the loss may yet be denied. It will be denied if the Commissioner is satisfied that the company carried on business in the year of incurring of the bad debt loss for the purpose of satisfying and securing the protection of s. 63C, unless the company has continued to carry on the same business in the year in which the loss carried forward is sought to be deducted.

Section 69: expenses for the preparation of an income tax return
10.83 Section 69(1) provides for the deduction of expenditure incurred by the taxpayer in the year of income for the preparation by a registered tax agent of a return required by or under the Assessment Act to be presented to the Commissioner in respect of the income of the taxpayer. Expenditure incurred by the personal representative of a deceased taxpayer in presenting the return of the income of the deceased is deemed to be expenditure incurred by the deceased (subs. (2)). Some comment was made on s. 69 in [6.292] above. The view was there taken that the expenses of preparing a return of income as distinct from the expenses of recording income are not deductible under s. 51(1).

Section 71: losses incurred by the taxpayer through misappropriation

10.84 Some attention was given to the provisions of s. 71 in [6.67]–[6.77] above. In one respect it allows a deduction beyond the operation of s. 51(1). The loss is an allowable deduction in the year in which it is ascertained, which may be a later year of income than that in which the loss was incurred for purposes of s. 51(1). In other respects the section may be narrower or wider in its operation than is s. 51(1). The section in its present form is the result of amendments made in 1963 following the decision of Kitto J. in *Levy* (1960) 106 C.L.R. 448 that losses which result from the action of a person who is not an employee are not deductible under s. 51(1). The decision is the subject of some comment in [6.68] above, where it is said that the decision in *Levy* is simply at odds with the Full High Court decision in *Charles Moore & Co. (W.A.) Pty Ltd* (1956) 95 C.L.R. 344. Section 71 is narrower in its operation than s. 51(1), in that it will not allow a deduction where the loss results from the action of a person employed solely for private or domestic purposes. In *Charles Moore* it was held that loss by the action of an armed robber was a relevant expense. It should follow that loss that results from action by a person employed solely for private or domestic purposes may be a relevant expense. A deduction under s. 51(1) could not be denied if an armed robbery in the circumstances of *Charles Moore* was carried out by a person employed by the taxpayer for domestic purposes.

10.85 Section 71 is also narrower in its operation in confining deductibility to a loss “of, or in respect of, money that is or has been included in the assessable income of the taxpayer”. Where a loss arises from some act of deprivation of property which is a capital asset, s. 51(1) will not allow a deduction: the expense is not a working expense. But whether money is a capital asset or a revenue asset, it is submitted in [6.70] above, is a matter of the way in which it is held, not a matter of its origin. A characterisation
of an asset in terms of its origin is simply unacceptable: it leads to fortuitous consequences. Thus the misappropriation by the wages clerk of the proceeds of a cheque drawn to pay the wages of employees will not give rise to a deduction under s. 71 if the cheque is drawn on an overdrawn bank account, an overdraft having been arranged.

10.86 The language of s. 71 which confines the operation of the section to a loss in respect of money “that is or has been included in the assessable income of the taxpayer”, may result in a wider operation for the section than the operation of s. 51(1). Money that has its origin in a transaction whereby its receipt is a derivation of assessable income—which is presumably the money identified by the words of s. 71—may in the manner in which it is held be a capital asset of the taxpayer's business, or, indeed, have ceased to be an asset of the business, the taxpayer having effected a drawing by taking cash or cheque for his private purposes, or by paying it to the credit of his private bank account. The deprivation of that money will give rise to a loss deduction under s. 71, when it would not give rise to a loss deduction under s. 51(1).

10.87 And the allowing of a deduction in respect of deprivation by a person employed—which imposes a test of relevance which picks on only one element in the circumstances—may involve a wider operation for s. 71 than the operation of s. 51(1). Charles Moore sets a very embracing test of relevance for purposes of s. 51(1). But at least in theory deprivation by a person employed may not always be a relevant deprivation.

Section 73: subscriptions to associations

10.88 Section 73 was the subject of some examination in [6.252]–[6.266] above. A deduction under s. 73 in respect of a subscription to an association may be available:

(i) in the case of s. 73(1), where the carrying on of a business from which assessable income is derived by the taxpayer is conditional upon the membership of the association;
(ii) in the case of s. 73(2), where the association carries out, on behalf of its members, any activity of such a nature that, if carried out by the taxpayer on his own behalf, its expense would be an allowable deduction to him; or
(iii) in the case of s. 73(3), where the subscription was paid by the taxpayer in respect of his membership of any trade, business, or professional association.

10.89 Subscriptions of these kinds are likely to be relevant expenses for purposes of s. 51(1), but they may not be. And a deduction under s. 73 will not be denied where deduction would be denied under s. 51(1) because the
subscription is a non-working expense.

10.90 The deductions allowable under s. 73 are thus in some respects wider than those that might be allowable under s. 51(1), though they are in some other respects narrower—there is a money limit of $42 in regard to each subscription in the cases of subss (2) and (3). Where the deductions allowable under s. 73 are narrower, the question is raised whether s. 73 excludes deductibility under s. 51(1). An argument might be made that s. 73 is a code. The view is taken, however, in [6.255] above that it should not be so regarded.

10.91 Deductibility of subscriptions to associations, whether under s. 73 or s. 51(1), is affected by s. 51AB. The section overrides s. 73 and s. 51(1) in denying a deduction of an outgoing to secure enjoyment of certain facilities. Section 51AB is the subject of some examination in [6.261] above.

Section 74: expenses of an election

10.92 Section 74(1) allows a deduction of expenditure in being elected as a member, or in contesting an election for membership of certain legislative bodies, including the federal parliament. Section 74(2) requires that any amount received by way of reimbursement should be treated as assessable income.

10.93 Expenses of this kind would be denied deduction under s. 51(1), either because they are not contemporaneous with the derivation of income as a member, or because they are not working—they relate to the acquisition of the office, and the office is, presumably, a structural asset. Maddalena (1971) 45 A.L.J.R. 426 is relevant.

Section 77: loss incurred in carrying on an exempt business

10.94 Section 51(1) is confined in its terms to the allowance of deductions incurred in deriving assessable income. Section 77 allows the deduction of a loss incurred by a taxpayer in carrying on an “exempt business” in Australia. “Exempt business” is defined in subs. (1) of s. 77 as a business the income, if any, from which would be exempt income. An illustration would be a business of working a mining property for the purpose of obtaining gold: s. 23(o).

10.95 The calculation of the amount of the loss is controlled by s. 77(2), so that no subtraction may be made which would not have been an allowable deduction if the income (if any) had been assessable income.

10.96 Where a deduction has in fact been allowed and a profit is derived from the exempt business in any of the following three years of income,
the profit will be assessable income to the extent of the amount of the loss that has been deducted.

Section 78(1)(a) and section 78A: gifts to funds, authorities and institutions

10.97 Section 78(1)(a) allows deductions of gifts, other than testamentary gifts made to certain funds authorities and institutions. In most circumstances such gifts would not be deductible under s. 51(1). Section 78 (1)(a) thus involves a significant extension of deductibility beyond what is allowable under s. 51(1).

10.98 Deductibility under s. 78(1)(a) is qualified in a number of ways. The gift must be of money, or of property purchased by the taxpayer within 12 months immediately preceding the making of the gift. The latter qualification is modified in relation to gifts of works of art by s. 78(1)(aa) and (ab) which make distinct provisions for the allowance of deductions in respect of these items. The amount of the gift where property is transferred is determined by s. 78(2).

10.99 Section 78A contains provisions denying deductibility of gifts made in circumstances where, among others, the amount or value of the benefit derived by the fund, authority or institution as a consequence of the gift may reasonably be expected to be less than the amount or value of the gift at the time it was made, or where the donor or an associate of the donor may reasonably be expected to obtain a benefit.

10.100 Section 78A is directed against the use of s. 78(1)(a) to obtain a tax advantage. The interpretation of the word “gift” in s. 78(1)(a) in McPhail (1968) 117 C.L.R. 111, Cyprus Mines Corp. (1978) 78 A.T.C. 4468 and Leary (1980) 80 A.T.C. 4438 has significantly reduced the need for s. 78A. In McPhail, Owen J. put an interpretation on the word that precludes a conclusion that a transfer of property is a gift where an “advantage of a material character [is] received by the transferor by way of return” (at 116). Cyprus Mines Corp. and Leary confirm this interpretation. In Leary Deane J. accepted that a “usual attribute” of a gift is that to be a gift the donor must act from a “detached and disinterested generosity”. If such an attribute is required s. 78A will be unnecessary where an associate of the would-be donor receives a benefit. But s. 78A will have an operation in circumstances suggested by Coppleson (1981) 81 A.T.C. 4019 where the property transferred will fall substantially in value if action is not taken by the transferee.

10.101 The operation of s. 78(1)(a) in allowing deductions of gifts is clearly wider than the operation of s. 51(1). Section 78(1)(a) has no test of relevance, nor any equivalent test, such as there is in s. 73. Gifts made to
funds authorities or institutions by a self-employed taxpayer, or by a company or trust conducting a business, will generally be denied deduction under s. 51(1). In some circumstances, however, a gift will be deductible because its purpose is to secure opportunities to do business, or to attract goodwill. A gift may persuade the donee institution that it should purchase its requirements of goods or services from the taxpayer: the gift has the same function as a discount allowed. A gift, if it is publicly acknowledged, may induce those who come to know of the gift to purchase goods or services from the taxpayer.

10.102 The deductibility under s. 51(1) of a gift to an institution that carries out activities which will further the interests of the taxpayer making the gift, will depend on considerations explored in [6.257–6.259] above in regard to subscriptions to an association.

10.103 A gift to an institution by an employee will rarely be deductible under s. 51(1). The outgoing must be relevant to the derivation of the income of the employee, not the income of his employer. Reference was made in [6.266] above to the interpretation that has been given to the judgment of Menzies J. in *Hatchett* (1971) 125 C.L.R. 494. If that interpretation is correct, and the judgment of Menzies J. is taken to establish the law, a deduction for a gift by an employee will be deductible only where he is required to make the gift by the terms of his employment.

10.104 Deductibility under s. 78(1)(a) is subject to s. 79C. The effect of s. 79C is, in general, to preclude a deduction under s. 78(1)(a) to the extent that it would create or increase a loss available for carry forward under s. 80. Section 80 is considered in [10.367]ff. below.

Section 78(1)(c): pensions, gratuities or retiring allowances to persons who are or have been employees or dependants of employees

10.105 Section 78(1)(c) provides for the allowance of a deduction where a taxpayer pays a pension, gratuity or retiring allowance to a person who is or has been his employee, or a dependant of his employee. The deduction is limited to the amount which in the opinion of the Commissioner was paid in good faith in consideration of the past services of the employee in any business operations which were carried on by the taxpayer for the purpose of gaining or producing assessable income.

10.106 Such a payment would not always be deductible under s. 51(1). A payment may be deductible under s. 51(1) only where it is a further reward for services that the employer is bound to pay, where it may be said to be made to resolve an “ever-recurring question of personnel” as in *W. Nevill & Co.* (1937) 56 C.L.R. 290 ([6.17] above), or where it will, by its
example, foster the goodwill of existing and future employees.

10.107 Section 78(1)(c) does not displace the operation of s. 51(1). The opening words of the paragraph in the reference to “sums which are not otherwise allowable deductions” preserve the operation of s. 51(1).

10.108 A director of a company is not necessarily an employee. An employee must hold his position under a contract of employment. A director may, however, be both a director and an employee: he may have a service agreement with his company.

10.109 Section 78(1)(c) is concerned, in its terms, with “sums paid”. There is a question whether the transfer of property other than money involves the payment of a sum. Whim Creek Consolidated N.L. (1977) 77 A.T.C. 4503, concerned with the meaning of the words “money paid on shares”, may suggest that it does. In any event, s. 21 may have the effect of deeming a sum to have been paid.

10.110 The Commissioner may under s. 78(1)(c) deny a deduction to the extent that, in his opinion, the amount was not paid in good faith in consideration of the past services of the employee. The fact that the payment is unreasonably high will have a bearing on the formation of his opinion. Where deduction is claimed under s. 51(1), the fact that the payment is unreasonably high may require a conclusion that the purpose of the payment was not such as to attract deductibility or that there was another purpose of the payment beyond a purpose that would attract deductibility. Where the inference is that there were two purposes in the payment, the one a purpose that would attract deductibility and the other a purpose that would make the payment irrelevant, an apportionment may be proper.

10.111 Deductibility under s. 78(1)(c) is subject to s. 79C. The effect of s. 79C is, in general, to preclude a deduction under s. 78(1)(c) to the extent that it would create or increase a loss available for carry forward under s. 80. Section 80 is considered in [10.367] below.

10.112 A pension, gratuity or retiring allowance may be an allowance, gratuity or compensation paid “in consequence of the retirement” of a person from an “office or employment” held by him in a private company (as defined in s. 6). In this event the circumstance that the amount of the payment is unreasonably high may attract the operation of s. 109, and this whether the payment is otherwise deductible under s. 51(1) or s. 78(1)(c). Section 109 is concerned with a sum paid or credited by a private company to a person who is or has been a shareholder or director of the company or a relative of a shareholder or director. To the extent that the sum exceeds an amount that, in the opinion of the Commissioner, is reasonable, it is not an allowable deduction and is, for most purposes, to be treated as a
dividend paid by the company. Section 109 is the subject of further comment in [10.348]–[10.358] below. The correlation between s. 109 and Subdiv. AA of Div. 2 of Pt III is considered in [4.159] above.

Section 82AAS and section 82AAT: contributions to a superannuation fund

10.113 Contributions made by a taxpayer to a superannuation fund to provide superannuation benefits for himself would not be deductible under s. 51(1). The fact that he is required by a contract of employment to make the contributions, would not make them deductible. The requirement might give the contributions a quality of relevance but they would not be出去ings: the contributions are made by way of investment. Contributions not required by the terms of a contract of employment could not be seen as relevant to any process of income derivation. They are not in any event出去ings.

10.114 Sections 82AAS and 82AAT, in allowing deductions of contributions made by an “eligible person” to a “qualifying superannuation fund” to obtain superannuation benefits for that person or his dependants, extend deductibility beyond s. 51(1). A “qualifying superannuation fund” is one the income of which is exempt from tax by virtue of para. 23(ja), or is a fund to which s. 23FB applies in relation to the year of income ([4.174] above). Deductibility under s. 82AAT is subject to s. 79C.

10.115 The deduction under ss 82AAS and 82AAT is intended to give to the self-employed, and to the employee who is not a member of an employer-supported fund, some equivalent of the tax advantage the employed person may have in that the latter is not treated as deriving income when his employer makes a contribution to a superannuation fund of which the employee is a member. “Eligible person” is defined so as to exclude a person of whom it is reasonable to expect that retirement benefits will be provided upon his retirement, or for his dependants in the event of his death, and those benefits will be attributable to contributions to a fund made by a person other than the relevant person, or will be paid out of moneys that will not represent the relevant person's contributions to a fund. The latter aspect of the exclusion is intended to cover the circumstance that a retirement benefit may be paid by an employer directly, instead of his providing a benefit by contributions to a fund.

10.116 The assumption that an employee does not derive income when his employer makes a contribution to a superannuation fund is the subject of some observations in [2.22] and [4.167] above.

Sections 82KM-82KS (Subdivision E of Division 3 of Part III): cost of thermal insulation of a dwelling used as the taxpayer's sole or principal residence
10.117 Sections 82KM-82KS allow a deduction of certain costs of thermal insulation of a dwelling owned and used by a taxpayer as his sole or principal residence. The provisions reflect a policy of encouraging energy conservation. Such thermal insulation costs would not be deductible under s. 51(1): they are not relevant to the derivation of income.

Section 120: distributions by co-operative companies

10.118 In [2.67]–[2.94] there is some discussion of the operation of the provision of Div. 9 of Pt III relating to co-operative companies, as defined in s. 117, and referred to in this Volume as Assessment Act co-operatives. Some of the receipts of an Assessment Act co-operative that would otherwise not be income because of the operation of the principle of mutuality are made income by s. 119. Not all such receipts are made income: interest receipts of an Assessment Act co-operative that would not be income because of the mutuality principle are not made income.

10.119 Where s. 119 does not extend to a receipt by an Assessment Act co-operative, and that receipt attracts the mutuality principle, a rebate or bonus—the words are taken from s. 120—paid to the member from whom the receipt comes, will not be deductible. While the rebate or bonus may be seen as a discount allowed on the charge made for the goods or services to which the receipt relates, it is not an expense incurred in deriving income.

10.120 Where s. 119 does extend to a receipt by an Assessment Act co-operative, the rebate or bonus would ordinarily be deductible by the co-operative under s. 51(1) as an expense in the nature of a discount, incurred in deriving assessable income. The operation of s. 51(1) in this context is confirmed by s. 120(1)(a), which allows a deduction of “so much of the assessable income of [an Assessment Act] co-operative as . . . is distributed among its shareholders as rebates or bonuses based on business done by shareholders” with the co-operative. The drafting of s. 120(1) is curious in its reference to the distribution of “assessable income”. Similar language in s. 71 used in relation to losses suffered by a taxpayer through embezzlement, is the subject of comment in [10.85] above. Deductibility under s. 51(1) does not depend on the actual outgoing being traceable to a receipt which involved the derivation of assessable income. In requiring a tracing, s. 120(1) has a narrower operation than s. 51(1). Presumably the tracing called for is a tracing through accounting entries, and not the equity tracing which s. 71 must contemplate.

10.121 Section 120(1)(b) allows a deduction of “so much of the assessable income of [an Assessment Act] co-operative company as . . . is distributed among its shareholders as interest or dividends on shares”. In this respect s.
120(1)(b) extends deductibility beyond what would be allowed by s. 51(1). In [6.301]–[6.307] above a distinction was drawn between an expense in deriving income and a distribution of income derived. A payment to a shareholder, from whatever fund it is made, whose function is to make a distribution of profits to a shareholder is not deductible under s. 51(1): it is not an expense in deriving income. A conclusion that the function of the payment is to make a distribution of profits is clearly appropriate where payment is made in the manner of a dividend. It may not be so easily drawn where the payment is made as interest on capital subscribed by a shareholder—the other situation dealt with in s. 120(1)(b). Such payment as interest is in a marginal area, in this respect like interest paid on convertible debentures where deductibility has been made to depend on the specific provisions of ss 82Lff. considered in [10.344]–[10.347] below.

10.122 There is another respect in which s. 120(1)(b) confers a privileged treatment on an Assessment Act co-operative. A distribution among the shareholders of a mutual association that is not an Assessment Act co-operative, will not in any circumstances be deductible by the association. To the extent that the association's receipts are not income because they are subject to the mutuality principle, non-deductibility of the distribution does not involve a disadvantage when compared with the treatment of distributions by an Assessment Act co-operative. But a mutual association may have income from non-mutual dealings—returns, for example, from the investment of its funds with non-members. To the extent that it has such income, the denial of a deduction of a distribution is a disadvantage when compared with the treatment of an Assessment Act co-operative. The deduction allowed by s. 120 (1)(b) extends to distributions made from any receipts of an Assessment Act co-operative, whether they are receipts made income under s. 119 or are receipts that would be income in any event.

10.123 The deduction allowed by s. 120(1)(c) applicable to an Assessment Act co-operative that has as its primary object the acquisition of commodities or animals from its shareholders for disposal or distribution (s. 117(1)(b)), involves privileged treatment for such a co-operative. Section 51(1) would not allow the deduction of an amount paid in repayment of a loan in the circumstances described in s. 120(1)(c).

**Provisions Allowing Deductions beyond the Operation of Section 51(1), by Allowing Deductions of Expenses that are Relevant but not Working, or are not Contemporaneous**

10.124 A number of specific provisions of the Act allow deductions in respect of outgoings that are relevant to the derivation of assessable income
but are not working, or are not contemporaneous. The deductions in all instances relate to outgoings. Where they involve the acquisition of assets, the assets are wasting assets—their cost is consumed in the derivation of income.

Section 53AA: payment which a lessee is liable to make because of his failure to perform a covenant to repair

10.125 In [10.24] above reference was made to the decisions in Peyton (1963) 109 C.L.R. 315 and in Foxwood (Tolga) Pty Ltd (1981) 147 C.L.R. 278 that a payment made on the disposition of property used to produce income or on the disposition of a business, may be a non-working expense, as an expense of disposing of the property.

10.126 In Peyton the payment was made by a lessee to the lessor as an amount in respect of repairs, in order to secure the lessor's consent to an assignment of the lease. Section 53AA is presumably intended to allow a deduction by specific provision for the expense which in Peyton was not deductible under s. 51(1).

10.127 Section 53AA requires that the lessee should have become liable to pay money because of his breach of a covenant in the lease that he will repair. A payment in discharge of such a liability is deductible by the lessee if the property is held or was held by the lessee for the purpose of producing assessable income. In allowing a deduction for a payment that is not contemporaneous with the holding of the property to produce income, s. 53AA may be seen as going beyond the operation of s. 51(1). So far as s. 53AA relates to a contemporaneous payment, it will allow a deduction beyond what would be allowable under s. 51(1), only so far as s. 53AA applies in a Peyton situation. A contemporaneous payment in discharge of a liability to pay which has arisen by reason of the non-performance of an obligation to repair would ordinarily be a relevant and working expense. It is a payment of an ever-recurring kind, akin to rent, and an expense of maintaining the leasehold interest. There are difficulties about the application of s. 53AA to a Peyton situation. The lessee in a Peyton situation may not as yet be in breach of an obligation to repair, so that no obligation to make a payment to the lessor by reason of non-performance has arisen. The lessee may make the payment for repairs that are due in order to secure the lessor's consent to assignment.

10.128 There is a specific provision in s. 26(1) that “any amount referred to in s. 53AA” received by a lessor is income of the lessor. The receipt by the lessor would be income in any event as a gain derived from property, or as compensation for an outgoing on revenue account that he may incur in
effecting the repairs himself. The authority for the operation of the compensation receipts principle would be *Carapark Holdings Ltd* (1967) 115 C.L.R. 653, discussed in [2.536]–[2.539] above.

**Sections 53F and 53G: costs of connecting plant for use in connection with decimal currency or the metric system of measurement**

10.129 Costs of converting plant for use in connection with decimal currency or the metric system of measurement are deductible exclusively under ss 53F and 53G. Such expenses would ordinarily not be deductible under s. 51(1), though they might have been deductible under the depreciation provisions considered in [10.130]ff. below. They would be deductible under s. 51(1) only where the item of plant is of such limited durability or significance that an expense to acquire it would be a working expense. Sections 53F and 53G are, by s. 53F(3) and 53G(3), made an exclusive code. There is no room for the operation of s. 51(1) or the depreciation provisions.

**Sections 54–62: deductions in respect of depreciation**

10.130 A group of sections of the Act concerned with the deduction of depreciation have a much wider application in regard to the deductibility of non-working expenses than those so far considered. Sections 54–62 provide for the deduction of depreciation during the year of income of any property, being plant or articles, owned by the taxpayer and used by him during that year for the purpose of producing assessable income, and of any property being plant or articles owned by the taxpayer which has been installed ready for use for that purpose and is during that year held in reserve by him. The word “depreciation” is not defined but the reference intended by the word is to the “wastage”, the fall in value of an asset over the relevant period.  

10.131 Section 55(1) provides for some correlation between the amount of deduction for depreciation and the actual decline in value of the item of property in the year of income. The Commissioner is required to make an estimate of the effective life of the property, and to fix the annual depreciation per centum accordingly. But the amount of depreciation allowed in a year of income as a deduction may be different from the actual decline in value for several reasons. The calculation of the amount of depreciation is made by reference to the historical cost of the property, and not its value at the commencement of the year of income. A deduction for depreciation thus becomes a deduction of the historical cost spread over the life of the asset. And the amount of depreciation may be different from
the actual decline in value, because the annual depreciation per centum fixed under s. 55(1) has been increased by some more specific provisions which provide for what might be called accelerated depreciation. One such provision is s. 57AG, which imposes a loading on normal depreciation rates applicable to certain units of property acquired under contracts entered into after 19 August 1980. Another such provision is s. 57AL which provides an optional accelerated rate of depreciation in certain situations. Moreover a number of provisions exclude the operation of s. 55 (1). The Commissioner's estimate of the effective life of the property is irrelevant when the rate of depreciation per centum in respect of an item of property is fixed by the statute. This is done by s. 55(2), which fixes the annual depreciation per centum of property listed in the subsection—property used by the taxpayer principally for the purpose of providing clothing cupboards, first aid, rest room or recreational facilities, meals or facilities for meals for persons employed by the taxpayer in his business or for the care of children of those persons. The rate fixed is 33 1/3 per cent. And the Commissioner's assessment of the effective life of property is irrelevant where the depreciation allowable is fixed directly by the Act in ss 57AE, 57AH, 57AJ, 57AK and 58 in respect of specified items of property—property used for the purpose of storage of grain, hay or fodder (s. 57AE), property used for the purpose of storage of petroleum fuel (s. 57AJ), property used in connection with basic iron or steel production (s. 57AK) and property used for the purpose of transporting petroleum (s. 58).

10.132 The depreciation provisions could have an operation in relation to a non-contemporaneous expense and in this respect are wider in their operation than s. 51(1). The cost of an item of property acquired for use in a process of income derivation might have been incurred before the commencement of the process. Where the asset is acquired for use in a business the incurring of the cost would generally be seen as the commencement of the business, if the business has not otherwise commenced, so that there is no want of contemporaneity. But an asset may be acquired in order to be leased to another in a process of deriving income from property. In such circumstances the principle that requires contemporaneity may deny any deduction if s. 51(1) were otherwise the applicable provision. Deductions are however allowable under the depreciation provisions. An inference that they are allowable is to be drawn from subss (1A), (1B) and (1C) of s. 56. These subsections provide for deductions for depreciation where property is used only for some part of a year of income for the purpose of producing assessable income, or is installed ready for use for some part only of a year of income. The deduction for depreciation is limited to a proportion of what would be
allowable if the property had been used at all times during the year for the purpose of producing assessable income, or had been installed ready for use at all times in the year of income. The assumption is that a cost incurred before use, or before installation for use, may attract depreciation deductions.

10.133 There will be circumstances where the asset is acquired for private purposes, and thereafter comes to be used in a process of income derivation. For example, a motor car, acquired and used for private purposes, might come to be used for professional purposes. In such circumstances, depreciation would first be allowed in the year in which the asset comes to be used in the process of income derivation, and it would be appropriate to regard the cost of the asset as the value at the time it first comes to be so used. A like approach is accepted in regard to the cost of items acquired for private purposes which are taken into the trading stock of a business. There is no clear support in the statutory provisions for determining cost in this way. Curran (1974) 131 C.L.R. 409 may be thought to offer judicial support in the case of the items that come to be trading stock, though the point is made in [7.24] above that the case is unacceptable in treating the shares as having been acquired, and then taken into trading stock.

10.134 The view in the last paragraph rejects a submission that the reference to “cost” in s. 56(1)(b) and in s. 62(1) will extend to the cost of a unit of property that at the time the cost was incurred was not intended to be used in a process of income derivation. An inference might be drawn from s. 61 to support such a submission. The Commissioner has a discretion under s. 61 to allow such deduction “as in his opinion is proper” where a unit of property acquired for private purposes comes to be used in a process of income derivation. And it would be said, on the authority of Anderson (1956) 11 A.T.D. 115, that a valid exercise of that discretion would determine the amount of the deduction on the assumption that the unit of property had been wholly used in a process of income derivation since its acquisition: s. 61 is not in its terms limited to circumstances where property, in the year of income in which depreciation is claimed, was used partly for private purposes and partly in a process of income derivation.

10.135 Anderson was concerned with a unit of property which was acquired for use partly in a process of income derivation, and is not directly relevant in the circumstances now considered. And the application of an Anderson approach in the circumstances now considered would require that assumptions should be made about the exercise of elections as to the method of depreciation or specific provisions determining rates of depreciation, which were not in fact open to the taxpayer.
10.136 If the submission is a correct interpretation of the Act, a taxpayer who acquired an item of property some years ago for private purposes, and now proposes to use it in a process of income derivation, would be advised to sell the item of property and acquire another; at least he would be so advised whenever the value of the unit is greater than a notional depreciated value that might be asserted on some assumptions about how the depreciation provisions would have operated had the unit been originally acquired and used in a process of income derivation.

10.137 There is another basic question about the meaning of “cost” for purposes of the operation of s. 56. A taxpayer may acquire property from another by way of gift, or he may acquire it in a transaction not at arm's length from a person who sells the item to the taxpayer at a price less than its market value. It is arguable that the meaning of “cost” will include the element of gift in the transaction by which the unit of property is acquired. An argument is made in [14.57]ff. below that the cost of an item of stock for purposes of the trading stock provisions may include the value of an element of gift. And a like argument is made in [12.78]ff. below that the value of an element of gift is a part of the cost of property acquired in a transaction in which a profit on realisation is income or a loss is deductible.

10.138 To be deductible under s. 51(1) an expense must be relevant to some process of income derivation. The parallel test of deductibility for depreciation requires use during the year of income for the purpose of producing assessable income, or installation during the year of income ready for use for that purpose. The parallel test may be less demanding than the test of relevance. An employee who uses his own property—a motor vehicle or some electronic equipment—in connection with his duties as an employee, may have difficulty in establishing the relevance of associated expenses. Those difficulties are considered in [8.38]–[8.90] above in relation to travelling, self-education and entertainment expenses. Where the employee claims depreciation on the item of property, it is presumably enough that he has in fact used the item in doing the work for which he is paid.

10.139 A deduction may be available under s. 51(1) for an expense which prima facie would attract depreciation deductions. Section 56(3), noted above in regard to repairs, will in these circumstances preclude any deduction for depreciation. The cost of acquiring a wasting revenue asset is deductible under s. 51(1) though, it has been submitted, the deduction should be spread over the life of the asset ([6.129] above). Whether deductible immediately or spread over the life of the asset, the cost will not enter the cost that may be the subject of depreciation deductions.

10.140 An item of property that is properly to be regarded as a wasting
revenue asset will have a limited effective life. If its effective life is substantial—it involves an enduring benefit—it will be a structural asset, and no deduction will be available under s. 51(1). The cost of the item is not a working expense. *B.P. Australia Ltd* (1965) 112 C.L.R. 386 and *Strick v. Regent Oil Ltd* [1966] A.C. 295 are relevant. Where a deduction is denied under s. 51(1) because the item of property involves an enduring benefit, there is the prospect of depreciation deductions in respect of the item. The depreciation provisions are not in their terms confined to costs that are non-working expenses, though this will generally be the area of their operation. In theory, there may be an expense denied deduction under s. 51(1), because of want of relevance, that would, if relevant, be regarded as a working expense. An employee's expense in providing himself with a small calculator which he uses in his employment may be an illustration. Such an expense would attract deductions for depreciation: the calculator would be an article used by him for the purpose of producing assessable income.

10.141 Some matters of principle raised by the detail of the depreciation provisions call for examination. These relate to the definition of property to which the provisions apply and to the method of allowance of deductions for depreciation, more especially the determination of “cost” and the consequences of disposal of an item of property.

**Property to which the depreciation provisions apply**

10.142 The words of s. 54 confine the operation of the depreciation provisions to “plant or articles” that are “owned” by a taxpayer and are “used by him” during the years of income for which depreciation is claimed “for the purpose of producing assessable income” or are “installed ready for use for that purpose” and held in reserve by the taxpayer during that year of income.

10.143 The meaning of the word “article” is the subject of an observation by Taylor J. in *Quarries Ltd* (1961) 106 C.L.R. 310 at 316: “I see no reason for denying the word ‘article’ the comprehensive meaning which it normally bears or for thinking that it was not used in the section by way of extension.” He considered that the word would not ordinarily comprehend a structure erected or built in situ but, in the case before him, he held that it did comprehend portable huts. If a wide meaning is given to the word “article”, the meaning of the word “plant” in its application to property which is not a fixture will not be significant.

10.144 The word “plant” has its ordinary meaning, extended in some respects and perhaps controlled by the definition in s. 54(2). The meaning
may be controlled by the reference to “machinery, implements, utensils and rolling stock”. Only one of these words, “machinery”, would embrace a fixture, and some argument might be made that a fixture should not be regarded as plant unless it has some kinship with machinery. That kinship could be that the item of property has a dynamic function. In fact, it will be seen, the word plant has been held to extend to a fixture that is static, if it plays a part in an industrial or commercial process. But there is room for insisting on a dynamic quality in characterising an item of property as plant where there is no industrial or commercial process, or where there is, but the item of property does not play a part in that process: the item may be a lift to convey passengers, an electricity generator that provides lighting only, or a hot water heater as an amenity.

10.145 In what follows, the discussion is confined to the meaning of plant where the item of property is a fixture. The whole of a building may be plant: a brick kiln or a cooling tower are the most obvious illustrations. A part of a building may play a part in an industrial process and thus be plant. A chimney whose function is to create a draught necessary for an industrial process has been held to be plant for purposes of United Kingdom legislation, and the decision would be followed in Australia (Re Nutley & Finn [1894] W.N. 64. Cf. Margrett v. Lowestoft Water & Gas Co. (1935) 19 T.C. 481). A distinction has been drawn in the Australian authorities between a building which plays a part in an industrial process and is, therefore, plant, and a building which merely houses plant, or provides a setting in which an industrial process is carried, and is therefore not plant: Broken Hill Pty Co. Ltd (1969) 120 C.L.R. 240 at 247, 263. In Wangaratta Woollen Mills Ltd (1969) 119 C.L.R. 1 McTiernan J. held that, save for the outer cladding, the walls and ceiling and floor of a building which constituted a dye-works were plant. The ceiling and walls were designed to prevent condensation and to carry away vapours, and the floor was designed to provide drainage to carry away excess dye. The exclusion of the outer cladding is not consistent with the view suggested by some words in the judgment of Kitto J. in Broken Hill Pty Co. Ltd (1969) 120 C.L.R. 240 at 263:

“I regard as plant the buildings which are more than convenient housing for working equipment and (considered as a whole, i.e. without treating as separate subjects for consideration the iron roofing and cladding of buildings where the main structural members are specially adapted to the needs of the processes to be carried on inside) play a part themselves in the manufacturing process, e.g. the holding bay for the basic oxygen steel-making installation as well as the very specialised building which because of its in-built equipment forms part of that installation, and also the casting pit (but not the slag pit).”
The notion of “plays a part” includes elements of the specific and the necessary. The pit for servicing a locomotive, held not to be plant (as the word is used in s. 62AA) in Moreton Central Sugar Mill Co. Ltd (1967) 116 C.L.R. 151, was specific to the industrial process carried on by the taxpayer but it was not necessary. It was, at most, convenient. Kitto J. said (at 157):

“All I need to say is that the word has never, I think, been held, and should not now be held, to include a structure built into the ground so as to form a static and permanent feature of the place in which a business may be carried on and having no other function than to provide a convenient stand for the performing of work in the business.”

The pit in Morton Central may be distinguished from the dry dock held to be plant for purposes of the United Kingdom legislation in I.R.C. v. Barclay, Curle & Co. Ltd [1969] 1 W.L.R. 675. The dry dock was both specific and necessary. The false acoustic ceiling constructed in Macquarie Worsteds Pty Ltd (1974) 74 A.T.C. 4121 so as to lessen the volume of air in a building that had to be processed by air conditioning, may be seen as neither specific nor necessary. Mahoney J. held the ceiling was not plant, though air conditioning was necessary to maintain the quality and temperature of air required for the taxpayer's industrial process: the taxpayer operated a spinning mill.

In terms of the distinction between playing a part and providing a setting, the ceiling in Macquarie Worsteds was indistinguishable from the ceilings in Imperial Chemical Industries of Australia & N.Z. Ltd (1970) 120 C.L.R. 396. In the latter case, Kitto J. (at 397) expressed the following view (which was confirmed by the Full High Court in ICI Australia Ltd (1971) 127 C.L.R. 529):

“This appeal which comes from a Board of Review under s. 196 of the Income Tax Assessment Act 1936–1969 (Cth), concerns (a) acoustic metal pan fittings and their supporting framework, forming ceilings in two office buildings owned and used by the appellant during the year of income ended 30 September 1961, and (b) such part of the electrical installations in one of those buildings as consisted of wiring and conduits therefor and trunking. The question in regard to each is whether it was ‘property, being plant, or articles owned by a taxpayer and used by him during (the year of income) for the purpose of producing assessable income’ within the meaning of s. 54 of the Act as it stood in relation to that year. If it was, depreciation is allowable in the assessment of the appellant's tax. The Commissioner has disallowed a claim for the depreciation and the board has upheld the assessment. . . . The truth is that the ceilings with which we are concerned do nothing for the appellant's business that they would not do for the business of any other occupier. They are in like case with the walls, floors, windows and doors, not to mention the roof: that is to say they are useful for anyone who wants to work in the building, and more useful than less
well thought out units of the same kind would be, but still only part of a general setting for work, not part of the apparatus of any income producing process. In my opinion they are not ‘plant’.”

10.148 A test in terms of what is “necessary” may be inferred from the judgment of McTiernan J. in *Wangaratta Woollen Mills*: an item of property is necessary to an industrial process if the process could not be carried on without it, or if the product would be unsatisfactory without it.

10.149 The distinction between playing a part and providing a setting must leave a substantial marginal area. It may be asked what view should be taken of the steel framework and cladding of a building that supports a gantry crane.

10.150 A building will be plant if it plays a part in a commercial process, as distinct from merely providing shelter for that process. It may not be easy to identify a building which plays a part in a commercial process. The fixtures —electric conduit and wiring and acoustic ceilings—of an office building in *Imperial Chemical Industries*, were held not to play a part. They were “parts of the general equipment of the building . . . and having no relevance to the activities of the appellant beyond the relevance they would have to any occupier's activities” ((1970) 120 C.L.R. 396 at 398-9).

10.151 In all the cases so far considered, the building was owned by the taxpayer who conducted the industrial or commercial process, and some of the language used in the judgments may suggest that, in order to be plant, an item of property must play a part in an industrial or commercial process carried on by the taxpayer who claims depreciation deductions in respect of it. This, it is submitted, is to confuse two distinct issues—whether the item of property is plant and whether it is used by the taxpayer to produce assessable income. An item of property may be plant though it is not presently used by any person to produce income. Indeed, s. 54 contemplates such a situation, by allowing depreciation in respect of an item of plant which is installed ready for use for the purpose of producing assessable income and during the year of income is held in reserve. The test of character as plant that it plays a part in an industrial or commercial process, should be reframed so that it refers to an item of property being adapted to playing a part in an industrial or commercial process. It follows that a building may be plant, and depreciation deductions in respect of it
may be available to a person who has leased the building to another who conducts the industrial or commercial process in which the building plays a part. The act of leasing the building to another is, it seems, a use of the item of property to produce income, income in the form of the rent reserved in the lease.

10.152 If leasing property to another is a use of property by the lessor to produce income, an issue will arise as to whether or not an item can be plant when the function of the item is to produce a private service and not to play a part in an industrial or commercial process. A test which would lead to a conclusion that such an item is plant may also justify a conclusion, in some circumstances, that an item which does not play a part in, but merely provides a setting for an industrial or commercial process, is plant. Stoves, hot water heaters and lifts that are fixtures in domestic dwellings let to others, are it is submitted, plant and depreciable under s. 51. Yet there is no industrial or commercial process in which they might play a part. They are plant because they have a dynamic function, as distinct from the static function performed by the elements of the buildings that simply provide shelter. The same items in an industrial or commercial building will attract depreciation deductions for the owner, whether he lets the building to another or himself uses the building in carrying on some industrial or commercial activity for the purpose of providing income. None of the items would be described as “machinery” so as to be within the definition of plant in s. 54(2)(a), but, it has already been submitted ([10.144] above), that word suggests a notion of plant that finds the quality of plant in dynamic function.

10.153 There is a reference in Imperial Chemical Industries to an electric generator in the basement of the building, installed ready for use in an emergency to provide power when the public supply failed ((1970) 120 C.L.R. 396 at 399). The case does not decide that depreciation was not available to the taxpayer in respect of that item of property. The question was simply not raised. The item is as much setting for the commercial activity as were the electric wires that might have carried the power generated by the generator. But the generator has an active function. The function of the wires is passive.

10.154 The limitation of depreciation deductions to items of property that are plant or articles involves the exclusion of buildings and fixtures that do not qualify as plant. Some extension of the notion of plant in relation to buildings and fixtures is achieved by s. 54(2)(b) applicable to certain fences, dams and other structural improvements on land which is used for the purposes of agricultural or pastoral pursuits, for the purposes of forest operations or for the purposes of pearling operations. And there is a further
extension by s. 54(2)(c), applicable to certain plumbing fixtures and fittings installed in premises by a person carrying on a business of producing assessable income, where those fixtures and fittings are provided principally for the use, for personal purposes, of persons employed by him in that business or for the care of children of those persons.

10.155 Provisions having the same effect as the depreciation provisions allow deductions in respect of the cost of hotel and apartment buildings used for traveller accommodation (Div. 10C of Pt III) and in respect of certain income producing buildings (Div. 10D of Pt III) ([10.212]ff. below). These and other provisions beyond s. 54(2) applicable to buildings and fixtures used in particular industries, in particular the mining industry, may be thought to achieve substantial coverage in allowing deductions in respect of the costs of wasting structural assets that are tangible.

10.156 Division 10B of Pt III, considered below in [10.239]–[10.269] makes provision for the allowing of deductions in respect of the cost of wasting structural assets that are items of commercial or industrial property. But there remain intangible wasting structural assets in respect of which no deductions are allowable. The cost of the ties—paid by way of premiums on leases— in *Strick v. Regent Oil Ltd* [1966] A.C. 295 would not attract deductions in Australia. No deductions are available in respect of the cost of goodwill that is a structural asset, though in this instance it may be said that the asset is not wasting.

10.157 A number of sections of the Act limit the operation of the depreciation provisions by providing expressly for deductions in respect of expenses that would otherwise attract their operation. Section 75B applies to certain capital expenditure incurred by a taxpayer who carries on a business of primary production, where the expenditure is incurred on the construction acquisition or installation of plant or a structural improvement for the purpose of conserving or conveying water. The whole of the expenditure is deductible in the year in which it is incurred. Section 75C makes similar provision in regard to certain expenditure on fencing incurred by a taxpayer carrying on a business of primary production. Where these provisions apply, depreciation under s. 54 is not available to the taxpayer who incurred the expenditure, or to another person. Thus, depreciation is not available to a person in respect of his cost of acquiring the plant or structural improvement from the person who incurred the expenditure (s. 54(5) and s. 54(7)).

10.158 Deductions may be available under other special industry provisions in respect of expenditure that would otherwise attract the operation of the depreciation provisions. These special industry provisions,
for example Div. 10 of Pt III in relation to general mining (s. 122H), allow
the taxpayer an election to take deductions under the special industry
provisions or the depreciation provisions.

10.159 Deduction under the depreciation provisions is available in respect
of property “used by [the taxpayer] during [the] year of income for the
purpose of producing assessable income” and in respect of property “which
has been installed ready for use for that purpose and is during [the] year
held in reserve”. Some comment on the meaning of use for the purpose of
producing assessable income was made in [10.151]–[10.152] above. The
words extend to the leasing of property to another. A consequence is that
the owner who leases may have deductions for depreciation earlier than the
lessee would have had if he had acquired the plant or article as owner.
Deductions are available to a lessor from the time he leases the plant or
article to another. Deductions are available to an owner who does not lease
only from the time he uses the property directly in a process of income
derivation, or installs it ready for such use. The outcome is that entitlement
to depreciation may be accelerated if plant or an article is leased by one
taxpayer to another.

10.160 The effect of s. 56 is that depr eciation is allowable only in respect
of the cost of a “unit of property”. The notion of “unit of property” has
been the subject of examination in a number of judicial decisions
concerned with the same words used in provisions providing for
investment allowances, earlier under ss 62AAff. and more recently under
ss 82AAff. In Ready Mixed Concrete (Vic.) Pty Ltd (1969) 118 C.L.R. 177
Kitto J. held that a concrete mixer powered by its own motor mounted on
the back of a truck was a unit of property to which the earlier investment
allowance prima facie applied, and that it was not excluded by s. 62AA(3)
(b) as being itself a “road vehicle . . . ordinarily used . . . for . . . the
delivery of goods”. In reaching the latter conclusion Kitto J. said (at 184):

“In my opinion, therefore, the transit mixers are property to which the section
applies, unless they are excluded from that category by subs. (3). That subsection
describes a number of classes of plant or articles, to none of which it is suggested
that the mixers can be held to belong unless it be those described in paras (b) and (f).
Paragraph (b) refers to ‘road vehicles . . . of the kinds ordinarily used for . . . the
delivery of goods (including the delivery of goods of a particular kind)’. Even
assuming that a component part of a road vehicle may be excluded from the section
by this paragraph, it is clear, I think, that a transit mixer is not within the description.
It is not really a component of a total vehicle comprising itself and the truck, being a
vehicle ordinarily used for the delivery of ready mixed concrete. Notwithstanding
the mode and degree of annexation, the truck and the mixer are functionally separate
and independent units of property.”
The concluding words of the quotation do not suggest that an item of property will not be a unit of property unless it is functionally separate and independent of other items of property. “Functionally separate and independent” are a description of the transit mixer, which had already been found to be a unit of property. The description was intended to explain why the mixer should not be characterised as a road vehicle.

10.161 A view that an item of property cannot be a “unit of property” unless it is functionally separate and independent of other items of property is rejected by McTiernan J. in *Wangaratta Woollen Mills Ltd* (1969) 119 C.L.R. 1, in holding that a piston and spring were a unit of property, even though they could not be used without a can into which they fitted. McTiernan J. said (at 13–14):

“Sliver cans are used in the spinning factory for other purposes besides use with spring and piston to hold a sliver. For example they are commonly used to hold fibre bobbins on removal from the machine. I therefore regard the can as one unit of property, and the spring and piston as another, as an additional attachment to enable the can to be used for a more specialised purpose. It is true that the spring and piston cannot be used without the can, but the same could be said of any attachment for a tractor such as a mower or post-hole digger operated from a power take off.”

The judgments of Kitto J. and McTiernan J. are referred to in *Tully Co-operative Sugar Milling Association Ltd* (1982) 82 A.T.C. 4454 where Thomas J., in holding that a pumping station was a unit of property, observed that pumps, which with starter motors and other items made up the pumping station, were also units of property. Thomas J. said (at 4459):

“In my opinion a component may be a unit of property for the purposes of s. 82AB in the context of a manufacturing system, if it can be shown to perform a discrete function, or if it can be shown to vary the performance of that system. Furthermore, where there is expenditure upon a complex group of items (as in the present case) I do not think that there is necessarily a single and absolute answer as to what the units are. To my mind the appellant is correct when it says that the mixed juice pumping station was a unit. The Commissioner may also be correct when he submits that the Kelly and Lewis pumps are units in respect of which claims could be made. If they are both units, or capable of being treated as units, the taxpayer may indicate the unit of property which he says he has acquired or constructed after 1st January 1976, and if it is in truth a unit of property he is entitled to the benefit of the section. It does not matter that he could also have nominated a smaller unit, or a number of smaller units of property.”

An item may presumably have a “discrete” function without having a function separate and independent of other items of property. A pump will not function without a motor to drive it. But there remains a question of the degree of separateness required by the word “discrete”. Thomas J. at one stage rejects the idea that a bolt or a nut has a discrete function, and at another is prepared to contemplate that it might have a discrete function (at 4458). One may need to go to the even more particular to find an item that has a function that is not discrete. It may be asked whether a taxpayer acquires a distinct unit of property if he galvanises steel components of a factory
already acquired and used, in order to increase their durability.

10.162 The reference in the passage quoted from the judgment of Thomas J. to varying the performance of the system, as a test of an item being a unit of property, may have been intended to accommodate the judgment of McTiernan J. in Wangaratta. In which event it could be inferred that he did intend the notion of “discrete” to require both separateness and independence. But it seems hardly appropriate to describe a pump as varying the operation of a motor.

10.163 The view expressed by Thomas J. that the taxpayer may indicate what is the unit of property where there is a larger item that is a unit of property and parts of that item which are also units, is not without its difficulties. If the taxpayer may indicate, the Commissioner may wish to indicate differently. Granted that the taxpayer's indication prevails in the circumstances of Tully Co-operative, it may be asked whether it will prevail where the taxpayer seeks to deny the operation of some provision of the Act. The taxpayer may have disposed of some part of a “system” which may be regarded as a unit of property. He may seek to avoid a balancing charge under s. 59 ([10.188]–[10.207] below) by indicating that he regards the system as the unit and not any part of it.

10.164 Where a taxpayer effects some change to existing plant or articles the question will arise whether the change brings into existence a unit of property in respect of which depreciation may be allowed. It may be possible to regard the costs of change as costs of the existing unit of property, though costs in an operation distinct from acquisition would not easily be so regarded. In some circumstances the costs will be costs of repairs deductible under s. 53, and any question of operation of the depreciation provisions is excluded (s. 56(3)). But the costs may not be deductible as costs of repairs. The actions of the taxpayer may amount to effecting initial repairs. They may be the reconstruction of an entirety. They may effect an improvement. They may adapt the existing plant or article to a new function. Where repairs are initial repairs, the principle by which deduction is denied asserts that the costs are to be treated as costs of acquisition of the item of property repaired. In this situation the case for treating the costs as costs of the item originally acquired, and allowing depreciation on this basis, must be strong, though the structure of the depreciation provisions is not readily adapted to allowing depreciation of costs incurred in an operation distinct from the original acquisition.

10.165 Where the actions of the taxpayer involve the reconstruction of an entirety, there is the prospect that there will have been a fresh acquisition of a unit of property and thus depreciation deductions will be available. But the coincidence of “entirety”—the judicial concept developed in
interpreting s. 53—and “unit of property”—the statutory concept embodied in the depreciation provisions—should not be assumed. It will appear from the discussion in [10.15]–[10.16] above that the judicial concept has not been expressed in the language of separate function. To the extent that a unit of property is a larger unit than an entirety there is the possibility that deduction will be denied under s. 53 and under the depreciation provisions.  

10.166 Where the actions of the taxpayer involve an improvement or the adapting of property to a new function, there is again the possibility that deduction will be denied under s. 53 and under the depreciation provisions. If a taxpayer for the first time galvanises the steel components of existing plant or articles to prevent corrosion, he may be taken to have improved, and not be entitled to a deduction for repairs. It was suggested in [10.160] above that the galvanising is not a unit of property. If the taxpayer effects changes by cleaning and repainting of the kind undertaken in *W. Thomas & Co. Pty Ltd* (1965) 115 C.L.R. 58, in order to adapt a building to a new use, he may be denied a deduction for repairs. Again it is not easy to identify a new unit of property which would justify the application of the depreciation provisions.

The requirement that the unit of property must be owned by the taxpayer

10.167 The property must be owned by the taxpayer if depreciation is to be an allowable deduction under s. 54. Where the building in which plant is installed is leased to the taxpayer, the law of fixtures must presumably be applied in determining whether depreciation of the plant is an allowable deduction to the taxpayer or to the lessor. Thus the law of fixtures will be relevant on the question whether plumbing fixtures and fittings, which are “plant” by express provision in s. 54(2)(c), are depreciable property. In this instance, if the fixtures and fittings are owned by the lessor, depreciation will not be allowable either to the taxpayer or to the lessor. While generally the use of property for the purpose of producing assessable income which is involved in leasing that property to another is sufficient to entitle the lessor to depreciation, this is not so where the property is plant only by virtue of s. 54(2)(c). The fixtures and fittings must be provided principally for the use, for personal purposes, of persons employed by the taxpayer who claims depreciation, or for the use of children of those persons.

10.168 The classical form of hire purchase agreement delays the passing of property in goods under hire purchase until the exercise of the option to buy by the payment of the last instalment. Where plant or articles used for the purpose of producing assessable income are being acquired under a hire purchase transaction they are not owned by the taxpayer who is acquiring
them, and strictly, s. 54 has no application. It is understood, however, that it is the practice of the Commissioner to allow the taxpayer either to deduct depreciation on the cash price as the cost of the plant or article and also to deduct the interest element in the instalments paid in the year of income, or, alternatively, to deduct depreciation on the total amount payable as the cost of the plant or articles, no further deduction being then allowed for interest.

10.169 If the Commissioner refuses to make these concessions it does not follow that the taxpayer acquiring goods on hire purchase will be entitled only to deduct the interest element in the instalments he pays. It is arguable that some further part of the instalments are deductible under s. 51 as payments for the use of the plant or article. In a simple leasing situation, the lessee is entitled to deduct under s. 51 periodical payments by way of rental of property used to produce assessable income. The Commissioner may however rely on the judgment of Walsh J. in *Poole and Dight* (1970) 122 C.L.R. 427 to support an argument that, apart from the interest element, the instalments are not deductible because they are for the acquisition of an asset, no basis of apportionment having been established. Payments expressed to be made for the acquisition of property are not to be regarded as payments for the use of that property simply because they are made during a period in which the taxpayer enjoys the use of that property, but prior to acquisition. At the same time payments expressed to be made for the acquisition of property will not necessarily be denied deduction, even when they are made after the acquisition of the property. Payments which are spread over the whole life of the property that has been acquired, may yet be regarded as payments for the use of that property. *Cliffs International Inc.* (1979) 142 C.L.R. 140, considered in [7.45] above, is relevant. Payments which are thus deductible over the life of the property cannot enter the cost of the property for purposes of depreciation deductions (s. 56(3)).

10.170 A transaction may be entered into which involves a lease which provides for payments described as rent, the amount of the payment being greater than the value of the current use of the property leased. The lessee may be given an interest in the property by a provision which, in one form, requires that the property, or some property in the same condition as the property leased, will be sold to the lessee at the conclusion of the lease for a sum determined in accordance with the agreement. In another form of transaction the interest may be given to an associate of the lessee. In *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645 the Commissioner unsuccessfully sought to deny a part of the payment by way of rent in the latter form of transaction. The case is discussed in [9.17]–
Specific anti-avoidance provisions have now been included in ss 82KH, 82KL and 82KJ, and Pt IVA may have some operation. The view is taken in [9.19] above that the High Court might be expected to overrule *South Australian Battery Makers*, so that the Commissioner might thereafter deny some part of the deduction for rent relying only on the words of s. 51(1). The denial of a deduction of some of the rent in the first form of transaction referred to is consistent with *South Australian Battery Makers*. A taxpayer who is the owner of property may be entitled to depreciation deductions where he leases that property to another. The leasing by the owner is a use of the property by him to produce income. The observation was made in [10.159] above, that this use commences with the lease. In the result an owner lessor may be entitled to depreciation deductions sooner than an owner who uses property directly in a process of income derivation. The latter will be entitled to deductions, at the earliest, when the property is installed by him ready for use.

**The method of allowance of deductions for depreciation**

10.171 The allowance of deductions for depreciation requires the fixing of what is referred to in s. 55(1) as “annual depreciation per centum” of a unit of property. As explained in [10.131] above, this fixing may require the action of the Commissioner under s. 55(1), or it may be done by the Assessment Act itself in provisions such as ss 55(2), 57AE, 57AH, 57AJ, 57AK and 58. In one instance—s. 57AG—both the action of the Commissioner and a fixing by the Act based on the Commissioner's determination are called for.

10.172 The Commissioner is required by s. 55(1) to make an estimate of the effective life of the unit and from this to fix the annual depreciation per centum. Strict compliance with s. 55(1) in regard to the fixing of the percentage depreciation by the Commissioner would appear to require a decision in respect of each unit of property. However, considerations of administrative convenience have dictated the fixing of percentage rates of depreciation in respect of a wide range of items of property by Income Tax Order 1217. Unless the Commissioner in a particular case is expressly asked, or himself decides, to make an estimate of effective life and thus determine rates of depreciation appropriate to particular items of plant, the percentage rates specified in I.T.O. 1217 will apply.

10.173 Section 56 provides for two methods of calculation of “depreciation allowable”—the diminishing balance method and the straight line (or prime cost) method. Unless the taxpayer exercises the option given him by s. 56(1) (b) (which must be exercised in accordance with s. 56A),
depreciation will be calculated in accordance with the diminishing balance method under s. 56(1)(a). The depreciation allowable under this method is one and a half times the annual depreciation per centum fixed under s. 55 (which includes a fixing by s. 55(2) or by the combination of s. 55 and s. 57AG) of the depreciated value of the unit of property at the beginning of the year of income. The meaning of “depreciated value” of a unit of property is dealt with in s. 62(1). It means the cost of the unit of property to the person who owns or owned the property at the time when depreciated value falls to be determined less the total amount of depreciation (if any) allowed or allowable in respect of that unit in the assessments of the income of that person for any period prior to that time. Thus if the unit of property cost the taxpayer $1,000 and the annual depreciation per centum is 10 per cent, the taxpayer under the diminishing balance method will be entitled to a deduction of 15 per cent of $1,000 in the first year, that is, $150, and in the second year a deduction of 15 per cent of $850 and so on. Where the taxpayer has exercised his option and the straight line method of depreciation applies, s. 56(1)(b) provides that the depreciation allowable shall be the percentage per annum fixed under s. 55 of the cost of the unit. Thus in the illustration just taken, if the taxpayer has elected the straight line method of depreciation, he will be entitled to a deduction of $100 in each of the ten years of effective life of the unit of property.

10.174 Save in the exercise of the option given by s. 56, or in certain special situations with which subss (2) and (3) of s. 56A are concerned, a change in the method of calculating depreciation to be allowed to a taxpayer may only be made with the leave of the Commissioner (s. 57).

10.175 Where the depreciation allowance is fixed directly by the Assessment Act in provisions such as ss 57AE, 57AH, 57AJ, 57AK and 58, the deduction for depreciation is determined by the section itself, and not by the provisions of ss 55 and 56. Thus s. 57AE(2) (a)(i) provides that “notwithstanding anything contained in ss 55, 56, 56A and 57 . . . the depreciation allowable to a taxpayer . . . in relation to a year of income in respect of a unit of property to which [section 57AE applies] . . . is 20% of the cost of the unit”. The method of depreciation in this instance is thus straight line. And the deduction for depreciation under those provisions is not affected by those subsections of s. 56, considered in [10.178] below, which are concerned with the reduction of the depreciation allowable where the taxpayer has used the property to produce income for only part of the year of income.

10.176 Mention has been made of s. 57AG which imposes a loading on normal depreciation rates applicable to certain units of property. Where the property was acquired by the taxpayer under a contract entered into on or
before 30 April 1981, the loading is 20 per cent of the percentage actually fixed. Where the property was acquired by the taxpayer under a contract entered into after 30 April 1981 the loading is 18 per cent. Thus, if a unit of property is now acquired, and it is depreciable on a prime cost basis at 10 per cent per annum, this will be increased to 11.8 per cent by s. 57AG. Alternatively, if the diminishing balance method of depreciation is used, the normal rate of one and a half times the prime cost rate—in the example 15 per cent—is increased by 18 per cent of that amount to 17.7 per cent.

10.177 Section 57AL, introduced in 1983, provides for accelerated depreciation of plant ordered after 19 July 1982. The accelerated rates apply only if the prime cost method of depreciation is used: s. 57AL(4). The taxpayer may elect that the section will not apply: s. 57AL(7). If the section does apply, the accelerated rate varies according to what the prime cost rate of depreciation would have been, but for s. 57AL (after loading pursuant to s. 57AG). If the prime cost rate of depreciation is 20 per cent or less, the accelerated rate is 20 per cent. If the prime cost rate of depreciation is above 20 per cent but below 33 1/3 per cent (after loading pursuant to s. 57AG) the accelerated rate is 33 1/3 per cent. There is no acceleration where the prime cost rate exceeds 33 1/3 per cent. Nor does s. 57AL apply to certain vehicles, works of art, structural improvements, and units of property dealt with by s. 57AH or s. 57AJ.

10.178 Subsections (1A), (1B) and (1C) of s. 56 were inserted in the section in 1979 to deal with the question of the amount of depreciation allowable for a year of income when a unit of property is first used to produce income, or is first installed ready for use, during a year of income. A unit of property might be acquired and used on the last day of the year of income, and a full deduction for depreciation calculated in accordance with s. 56(1)(b) claimed in respect of that year of income. The subsections adopt a mechanical method of determining the amount of depreciation allowable in such circumstances, a method which simply reflects the number of days during the year of income during which the unit of property was not used to produce income, or was not installed ready for use in this way.

10.179 Presumably, the subsections apply whether or not the first use for the purpose of producing income, or the first installation for the purposes of such use, occurred during the year of income. This is the inference from the opening words of subs. (1B). There is then the greater problem of correlating the operation of the subsections with s. 61, which is concerned with circumstances where the use of property has been “only partly for the purpose of producing assessable income”. The matter is further considered in [10.208]–[10.211] below. The problems of correlation will arise in some situations where the depreciation allowable is determined directly by the
Assessment Act in provisions such as ss 57AE, 57AH, 57AK and 58. Subsections (1A) and (1B) of s. 56 have no application unless adopted. They are adopted by s. 57AG(3) and s. 57AK(b). But s. 61 will apply. All the sections referred to provide for the allowance of depreciation under s. 54—at least that is the inference from their drafting. The Commissioner's discretion under s. 61 is attracted where a deduction would “otherwise [be] allowable under s. 54”.

10.180 The amount of depreciation allowable by the operation of s. 56 depends ultimately or immediately on the “cost” of the unit of property. Where diminishing balance is applicable the relevant percentage is applied to the “depreciated value”, which in turn is defined in s. 62 as the “cost” of the unit of property less the total amount of depreciation allowed or allowable in respect of the unit in assessments of the owner. Where straight line applies, the relevant percentage is applied to the cost of the unit. Where the amount of the depreciation allowance is determined directly by the Assessment Act under ss 57AE, 57AH, 57AJ, 57AK and 58, the relevant percentage is applied to the “cost” of the unit (ss 57AE(2), 57AH (3), 57AJ(4), 57AK(5) and 58(4)). There are questions as to the meaning of “cost”.

10.181 Where the circumstances do not attract the operation of the provisions of ss 56(4), 62(2) or 62(3), “cost” is a matter of actual cost, the word having its ordinary meaning, and the question becomes one of the appropriateness of regarding as costs only direct costs. A like question, it will be seen ([14.30]ff. below), arises in determining the cost of stock for purposes of the trading stock provisions of the Act. In that context the question is expressed in terms of the appropriateness of direct costs as against “on-costs”. If the expenses are treated as costs of stock, deductibility is deferred by the operation of s. 28 until the stock is realised. The taxpayer, in regard to the cost of trading stock, will wish to take a direct cost approach so that other expenses may enjoy deductibility under s. 51(1) without any deferral by s. 28. And he will not wish to treat as costs for purposes of s. 28, expenses not deductible under s. 51(1). If such expenses are treated as costs, there will be a fortuitous item of assessable income, as a result of the operation of s. 28, that will be corrected only when the stock is disposed of. In regard to the cost of property subject to depreciation, the taxpayer will wish to take an approach that will treat as costs any expenses that are not deductible under s. 51(1). Kitto J. in Broken Hill Pty Co. Ltd (1968) 120 C.L.R. 240 adopted a view of cost for purposes of the operation of Div. 10 (General Mining) of Pt III, which would confine the expenses which are costs to those that are directly related to the acquisition of the unit of property. He held (at 265) that the costs of
demolition of an old building were not costs of a new building that replaced the old:

“... the demolition expenditure of structure A is, in my opinion, an expenditure which the original erection of that structure makes it necessary for the landowner to meet some day; and whether it is best treated for accountancy purposes as a cost to be dealt with in the same way as the cost of structure A, or as if it were part of the cost of structure B, or as a charge in a capital account relating to the land, it is in point of fact, considered as a cost, a cost of obtaining a site suitable for the new structure, and not a cost of the new structure itself. It stands in clear contrast with expenditure on excavations for the foundations of a new structure. No doubt that expenditure is part of the cost of the new structure, but the reason is that the excavations do not bring about any general advantage for the land: on the contrary, the only purpose they serve is peculiar to the new structure. Even in the common case where a site on which plant is to be erected has first to be cleared of trees, I should think that the correct view would be that the clearing is an improvement to the land rather than part of the installation of the plant, for its effect is upon the general usefulness of the land and accordingly its cost is part of the cost of the improved land and not part of the cost of the plant. A fortiori where the site has to be cleared of a structure which has been artificially placed in a position where it is an obstacle to the installation of the plant but would equally be an obstacle to other uses for the site, it seems to me that the cost of removing the obstacle is an expense which the taxpayer who installs the plant has taken upon himself by putting the obstacle there in the first place or by acquiring the land with the obstacle upon it. It is part of the cost of getting the land he needs for the plant, and not part of the cost of the plant.”

The treatment of the costs of demolition might have been different if the taxpayer had contracted with another to have the old buildings demolished and the new buildings erected. An expense may be a direct cost to the taxpayer though it reflects an on-cost incurred by the person who has supplied an item of property to the taxpayer. The earlier decision of Kitto J. in *B.P. Refinery (Kwinana) Ltd* (1960) 12 A.T.D. 204 may illustrate. The on-costs of the contractor who built a refinery for the taxpayer included temporary accommodation for workmen that was in due course demolished by the contractor. The taxpayer's costs of the items of plant included in the refinery were held to extend to a share of the costs of the contractor in respect of the temporary accommodation. The contract provided for payment of a fixed amount for the construction of the refinery, plus an amount equal to the contractor's expenses.

10.182 The view expressed by Kitto J. in *Broken Hill Pty Ltd* that expenses of excavations for foundations are costs of the new building, would support a submission that the cost of plant for depreciation purposes would include not only the purchase price but also any customs duty and expenses of obtaining delivery. The expenses are specific to the item of property.

10.183 Expenses of installation, where the functioning of the item requires that it be a fixture, may qualify as costs: it would be said that the item is not yet plant until it is installed. Installation expenses of other items could
be regarded as expenses that come too late, and are not costs of the item. The argument for treating installation expenses as costs would assert that any expenses that are incurred prior to the moment when the item is first used or installed ready for use do not come too late. In *Lister Blackstone Pty Ltd* (1976) 134 C.L.R. 457 the High Court allowed a deduction under s. 51(1) of the expenses of moving trading stock to new premises. The question whether the expenses were part of the cost of the trading stock and thus subject to the operation of s. 28 was not raised. There is room for an argument that the expense of moving an item that has already been acquired as trading stock is not a cost of trading stock, and for a parallel argument in regard to depreciable property. The expenses of moving plant to a new location could be the subject of depreciation deductions only as costs of the plant. The expenses are not costs of an additional unit of property. The expenses might possibly be deductible as working expenses under s. 51(1). Against this possibility is the concession by the taxpayer in *Lister Blackstone Pty Ltd* that “the cost of preparing the new premises and of moving plant and equipment thereto was . . . an item of expenditure on capital account” (at 462, per Jacobs J.). The decision of Kitto J. in *Broken Hill Pty Co. Ltd* (at 260–261) that the demolition expenses were not working expenses is also against the possibility.

10.184 There are a number of provisions directed against tax planning that would seek to give a high cost to a unit of property in a purchase from another in a transaction not at arm's length. Section 60(1) expresses a general principle that where a person has acquired any property in respect of which depreciation has been allowed or is allowable he shall not be entitled to any greater deduction for depreciation than that which would have been allowed to the person from whom the property was acquired if that person had retained it. There is a proviso which would increase the amount of depreciation that may be deducted by the buyer by the amount of any balancing charge under s. 59 included in the assessable income of the seller as a result of the transaction. The operation of s. 59 is explained in [10.188]–[10.207] below. Moreover, s. 60(2) gives the Commissioner a discretion to allow depreciation calculated by reference to the buyer's actual cost, where the Commissioner is of opinion that the circumstances are such that depreciation should be so calculated.

10.185 Section 60 will be effective to defeat planning to give an artificially high cost to a unit of property for purposes of depreciation where depreciation in respect of the property has been allowed to the person from whom the taxpayer acquired the property. But it is ineffective where the property was not depreciable in the hands of that person. An artificially high cost may of course generate income for the seller. But the seller may
be a non-resident supplier who is not subject to Australian tax. Provisions against planning to give a high cost were added to the Assessment Act in 1979. Where the taxpayer's allowable deductions are calculated under s. 56(1)(b) (straight line) the control is in s. 56(4). Where his allowable deductions are calculated under s. 56(1)(a) (diminishing balance) the control is in s. 56(3). The cost of the unit of property is deemed to be the amount that would have been the cost of the unit if the parties to the transaction had dealt with each other at arm's length in relation to the transaction.

10.186 Sections 56(4) and 62(3) have no application when depreciation allowable is not calculated under s. 56. Section 56AE (s. 57AE(3)), s. 57AH (s. 57AH(6)), s. 57AJ (s. 57AJ(4)) and s. 57AK (s. 57AK(6)) either contain their own provisions directed against planning to give a high cost, or expressly adopt s. 56(4).

10.187 Section 57AF imposes a limit on the cost by reference to which depreciation may be calculated where the unit of property, subject to some exclusions, is a motor vehicle that is a motor car or station wagon. The limit is indexed under the provisions of the section.

The consequences of disposal

10.188 Where any property of a taxpayer in respect of which depreciation has been allowed or is allowable is disposed of, lost or destroyed at any time in the year of income, s. 59 makes the depreciated value of the property at that time, less the amount of any consideration receivable in respect of the disposal, loss or destruction, an allowable deduction. However, if the consideration receivable exceeds the depreciated value, the excess, to the extent of the sum of the amounts allowed and allowable in assessments for income tax in respect of depreciation, must be included in the taxpayer's assessable income of that year. An amount thus made assessable income is referred to in subs. (2A) of the section as a “balancing charge”. The operation of s. 59 to the extent that it would bring an amount in as assessable income in the year in which a unit of property is disposed of, lost or destroyed, is qualified by subss (2A), (2B), (2C), (2D) and (2E) of s. 59. On the request in writing of the taxpayer, made when lodging his return of income or within such further time as the Commissioner allows, the balancing charge, instead of being brought in as assessable income, may be applied successively to reduce: (i) the cost for the purposes of calculating depreciation of any unit of property acquired by the taxpayer during the year of income as a replacement; (ii) the cost for the purposes of calculating depreciation of any other unit of property acquired by the
taxpayer during the year of income; and (iii) the depreciated value at the
beginning of the year of income of other units of property. By s. 59(2D)
the taxpayer, if he has not already made a request in the year of disposal,
loss or destruction, may make a request not later than the second year of
income after the year of disposal, loss or destruction, that the balancing
charge be applied to lower the cost of a unit of property acquired in the
year of request to replace the unit disposed of, lost or destroyed. Section 59
(1) does not in its terms refer to a “unit” of property. But other subsections
do, and the reference to “depreciated value” imports the concept of a unit.
If the disposal is of part of a unit, there is no room for the operation of s.
59. The scope of the concept of unit, considered in [10.160]–[10.166]
above, becomes critical.

10.189 “Consideration receivable” is expressly defined in subs. (3) of s. 59
as follows:

(a) in the case of a sale of the property—the sale price less the expenses of the sale
of the property;
(b) in the case of loss or destruction of the property—the amount or value received
or receivable under a policy of insurance or otherwise in respect of the loss or
destruction;
(c) in the case where the property is sold with other assets and no separate value is
allocated to the property—the amount determined by the Commissioner;
(d) in the case where property is disposed of otherwise than by sale—the value, if
any, of the property at the date of disposal.

10.190 Paragraph (c) suggests the importance in a conveyancing
transaction involving the disposal by sale of units of property in respect of
which depreciation has been allowed or is allowable, that the sale
transaction should allocate values to such units of property. The seller, by
an allocation is in a position to determine how s. 59 will operate in his
case. If no allocation is made the consideration receivable will be the
amount determined by the Commissioner, and the amount so determined
may result in s. 59 operating in a way which the seller would not have
chosen. The buyer of property will of course also have an interest in the
setting of the “consideration receivable” for purposes of s. 59, if he intends
to use the property in a process of income derivation. Where the
consideration receivable has been set so as to give an allowable deduction
to the seller, the effect will be to limit the amount of depreciation which
may be claimed by the buyer. Presumably, it is not open to the buyer to say
that his costs exceeded the value allocated to the property.

10.191 The significance of an allocation relevant to para. (c), or the setting
of a sale price relevant to para. (a) has been very much diminished by the
addition to s. 59, in 1979, of subss (4) and (5). Where there is a disposition of property by a taxpayer by sale and

(i) the Commissioner is satisfied that the taxpayer and the other party to the sale were not dealing with one another at arm's length in relation to the disposal, and
(ii) the consideration receivable by the taxpayer was less than the market value immediately before the time of disposal, and less than the depreciated value of the property immediately before the time of disposal,

the consideration receivable by the taxpayer in respect of the disposal is deemed to be that market value or that depreciated value, whichever is the less: s. 59(4). “Consideration receivable” for this purpose is determined by s. 59(5). In its application to a sale of property with other assets, s. 59(5) would make the consideration receivable the amount allocated to the property in the agreement. The circumstances are, it seems, within s. 59(5)(a)(i). The application of s. 59(5) to any circumstances requires that the Commissioner be satisfied that the taxpayer and the other party were not dealing with one another at arm's length. It may be asked whether the Commissioner may validly be satisfied where the transaction was in all respects an ordinary commercial dealing between two unassociated parties who agreed on an allocation of value to the unit of property.

10.192 Section 59(4) will apply to a sale of property in respect of which depreciation has been allowed or is allowable where that sale does not include other assets, and it will apply to a sale of property with other assets where no value has been allocated to the property sold and a determination has been made by the Commissioner as contemplated by s. 59(3)(c). In the latter situation the Commissioner's power to determine the consideration receivable provided for in s. 59(3)(c) is not thought to be enough to protect the Commissioner. The sale of the property in respect of which depreciation has been allowed or is allowable with other assets, may have been for a total price that is less than the market value of that property. The Commissioner's power to determine the consideration receivable for purposes of s. 59(3) is, presumably, limited so that the consideration receivable may not exceed the total price, and it may also be limited so that the Commissioner's determination must reasonably distribute the total price among the assets sold. Where the amount determined by the Commissioner under s. 59(3)(c) is less than the market value and less than the depreciated value, and the taxpayer and the other party to the transaction were not at arm's length, the consideration receivable is deemed to be the lesser of the market value and the depreciated value.

10.193 The question is raised in [10.191] above whether parties may validly be regarded as not acting at arm's length, so that s. 59(4) is
attracted, simply because they have made an allocation of value to a unit of property in a transaction involving the sale of depreciable property with other assets. If they cannot be validly so regarded, the Commissioner will be denied the operation of s. 59(4). In which event the correctness of a view that emerges from some of the judgments in Ferling (1966) 115 C.L.R. 603 will be important. This view is that an amount specified in the agreement by which property is sold with other assets will not be the “separate value allocated to the property” for purposes of s. 59, unless it is a real value and not simply a value adopted for the purposes of bringing about tax consequences.

10.194 Whatever be the effect of the amount set by the agreement in regard to what is assessable income of the seller or an allowable deduction to the seller, it may well be that it is irrelevant in setting the cost to the buyer, save to the extent that it has resulted in a balancing charge to the seller which will affect the ceiling imposed by ss 60(1) and 62(2) on the depreciation which may be allowed to the buyer. The buyer's cost is not necessarily determined by the definition of consideration receivable in s. 59(3). Where property is sold with other assets, it is arguable that an amount allocated is a cost only if it can be shown that there was a divisible contract in relation to the property. The allocation of a value to property in a contract does not necessarily make the contract divisible in relation to that property (Comptroller of Stamps v. Martin [1967] V.R. 369).

10.195 The meaning of “property sold with other assets” was the principal issue raised by Ferling. The case might be thought to have decided that where the property in question is a fixture—for example, a building which is made depreciable by s. 54(2)(b)—a sale of the fixture as part of the land is not a sale of the fixture “with other assets”, with the result that such a sale does not produce a “consideration receivable” and s. 59 can have no application. What is sold is the land of which the fixture forms a part.

10.196 Such an interpretation of s. 59(3)(c) has been questioned in the Federal Court in Mullins (1981) 81 A.T.C. 4643. The interpretation may have had the virtue that it denied success to tax planning which sought to exploit s. 59 by a sale of land with a depreciable fixture, at a very low value allocated to the fixture. But success is now in any event denied by s. 59(4) and (5).

10.197 The judgments in Henty House Pty Ltd (1953) 88 C.L.R. 141 amount to a decision that a resumption of property involves a disposition by sale. In applying s. 59(3)(c) the Commissioner adopted the values assigned to units of property by the Department of the Interior in calculating the amount of compensation payable on the resumption. The values were adopted not as values allocated to the units of property, but as
the bases on which the Commissioner exercised his power to determine the amounts of consideration. *Henty House*, in holding that the resumption involved a sale of the fixtures that were part of the property resumed, is inconsistent with *Ferling* so far as the latter decides that units of property that are fixtures are not sold with other assets when the property of which the fixtures are part is sold.

**10.198** Section 59(3) requires that a distinction be drawn between a loss or destruction of property and a disposal. Where property is lost or destroyed, the consideration by reference to which the balancing charge or allowable deduction is calculated is limited to “the amount or value received or receivable under a policy of insurance or otherwise in respect of the loss or destruction” (s. 59(3)(b)). Where, however, property is “disposed of otherwise than by sale”, the consideration receivable is the value of the property at the date of disposal.

**10.199** Machinery that has become defective may be replaced, and the original machinery treated as scrap. If these circumstances are treated as a destruction any allowable deduction will be calculated on the basis that there is a nil consideration receivable. There may subsequently be a disposal on the sale of the scrap, but this will, presumably, not be a relevant event under the depreciation provisions, though the proceeds might be held to be income as proceeds of sale of a revenue asset that has a nil cost, s. 82 being applicable. If treating the unit of property as scrap is held to be a disposal, there will be consideration receivable of the value of the property at the time it is so treated. Holding that there is a disposal will require a very wide meaning for the words “disposed of”, perhaps wider than the wide meaning considered appropriate by the High Court in *Henty House*. Williams, Webb, Kitto and Taylor JJ. considered that the words “should be understood as meaning no less than ‘becomes alienated from the taxpayer’” ((1953) 88 C.L.R. 141 at 152). If treating the unit of property as scrap is held to be a disposal at its value at that time, on the subsequent sale of the scrap there will, presumably, be income or loss depending on the amount of the proceeds, a cost being allowable of the value at the time of disposal. The argument would be that the scrap is a revenue asset.

**10.200** *Henty House* contemplates a wide meaning for the word “loss” in s. 59. It is enough that the item “ceases to be physically accessible” to the taxpayer ((1953) 88 C.L.R. 141 at 152 per Williams, Webb, Kitto and Taylor JJ.).

**10.201** The calculation of a balancing charge or an allowable deduction under s. 59 is based on the “consideration receivable”. It would appear that consideration is receivable in respect of a disposal loss or destruction
though the amount has not yet been ascertained. In this respect there may be a difference between accounting for depreciation, and accounting generally by an accruals basis taxpayer where the issue is whether a receivable has been derived. Williams, Webb, Kitto and Taylor JJ. said in *Henty House* (1953) 88 C.L.R. 141 at 155–6:

“Uncertainty may be due, in the case of an ordinary sale of depreciated property, to the fact that the price has still to be fixed by arbitration or otherwise by reason of the terms of the sale contract; or it may be due, in the case of loss or destruction, to the fact that an assessment has to be made under a policy of insurance; or it may be due, in the case of a sale of depreciated property together with other property, to the fact that the Commissioner has not yet determined an amount under subs. (3)(c); or it may be due, in the case of a disposal otherwise than by sale, to the fact that the value of the property is undetermined. But the existence of the uncertainty, for whatever cause . . . afford[s] no ground for denying to s. 59 the construction which its precise terms require.”

**10.202** Section 59AA was inserted in 1952 to overcome the decision in *Rose* (1951) 84 C.L.R. 118 that the words “disposed of” in s. 59 did not include a change in the interests of persons in property, arising, for example, from the formation or dissolution of a partnership or a variation in the constitution of a partnership. By s. 59AA, where such a change in interest occurs, the provisions of the Act relating to depreciation now apply as if the person or persons who owned the property before the change had, on the day on which the change occurred, disposed of the whole of the property to the person, or all the persons by whom the property is owned after the change for a consideration equal to the amount specified in the agreement in consequence of which the change occurred as the value of the property for purposes of that agreement, or, if there is no such agreement or no amount is so specified, an amount determined by the Commissioner. It will be noted that the effect of s. 59AA is to preserve to the parties a measure of control, by specifying a value of the property in the agreement, of the kind available by virtue of s. 59(3) in regard to other dispositions of property in respect of which depreciation has been allowed or is allowable. The measure of control is significantly limited by s. 59AA(2), added in 1979. Where the amount specified in the agreement is less than the amount that was the market value of the property immediately before the time when the change occurred, and is also less than the depreciated value immediately before that time, the depreciation provisions will operate as if there had been, at the time when the change occurred, a disposal of the property for a consideration equal to the market value of the property immediately before the change, or the depreciated value immediately before the change, whichever is the less.
Section 59AA(2) also provides that the depreciation provisions apply in the circumstances as if “the person or persons who owned the property after the change had, at the time when the change occurred, acquired the property at a cost equal to the amount specified in the agreement”. The effect is to impose a penalty of lost depreciation deductions—a fall out—if a low value has been specified in the agreement. Section 59AA(2) joins s. 62(2) in expressly determining the cost for purposes of depreciation deductions for the person acquiring, where property has been acquired from another person to whom depreciation had been allowed or is allowable. There is a limit to the buyer's cost imposed by s. 60(1). Where the limit operates, the person acquiring the unit of property is deemed to have acquired it at a cost equal to the depreciated value of the unit immediately prior to the time of acquisition, plus the amount of any balancing charge included in the assessable income of the seller. Section 62(2) has no application where the buyer has acquired at a price less than the depreciated value in the hands of the seller. There will be no operation of s. 60(1), and thus no operation of s. 62(2). Section 59AA(2) does have an operation in these circumstances.

There is no parallel operation for s. 59 where s. 59AA has not been engaged. The point has already been made that the cost to the buyer is not necessarily the amount of the consideration receivable by the seller, whether the amount provided for in the agreement by which the property is disposed of or the amount deemed to be the consideration receivable by the operation of s. 59(4) and (5). Where there is a sale of the property subject to depreciation without any other assets, it may be argued that the buyer's cost includes the gift extended by the seller in the low amount of the sale price. Where the sale is made with other assets, the value allocated to the property subject to depreciation may not in any event be properly regarded as the price under the contract, save where the contract is divisible.

There is a question whether gift is a disposal for purposes of s. 59. It will be recalled that Williams, Webb, Kitto and Taylor JJ. in *Henty House Ltd* (1953) 88 C.L.R. 141 considered that the words “disposed of” should be understood as meaning no less than “becomes alienated from the taxpayer”. If death is a disposal, the consideration receivable will be the value of the property at the date of death (s. 59(3)(d)).

Where the property in question was an asset of a partnership, and s. 59AA operates on death of a partner, there will be a question whether any amount specified in the partnership agreement or some other agreement between the partners can be said to be an “amount specified in the agreement in consequence of which the change occurred as the value of the property for purposes of that agreement”. If it cannot, or no amount has
been specified, the death will be a deemed disposal, in accordance with s. 59AA, for a consideration of an amount determined by the Commissioner, which may be the market value of the property. Where the death of a partner brings about a dissolution of a partnership or a dissolution and an automatic vesting in the other partners of the interest of the deceased, the words of s. 59AA(1) would appear to be applicable. Where the partnership business is, under the partnership agreement, carried on by the surviving partners for themselves and the estate of the deceased there may not be a dissolution (Peterson (1960) 8 A.I.T.R. 119) though it is arguable that there has been a variation in the constitution of the partnership so as to engage the operation of s. 59AA.

10.207 Where the assets of a business are disposed of, lost or destroyed and in consequence the business ceases to be carried on, the effect of s. 59 may be to include in the assessable income of the person who carries on the business a substantial amount by way of balancing charges. There will thus be a bunching of income which the individual taxpayer, because of the progressive rate structure, may regard as a hardship. Section 59AB gives the individual taxpayer some relief against such bunching, provided he has not already become entitled to relief by way of the averaging provisions (Div. 16 of Pt III), and provided he has not requested under subss (2A) or (2D) of s. 59 that the balancing charge be applied in reduction of the costs or depreciated values of other properties instead of being included in his assessable income. The relief given by s. 59AB follows the same pattern as Div. 16A of Pt III, which relates to the income of an author or inventor. There is a calculation of a notional income by subtracting from taxable income a part of the abnormal income which arises from the balancing charges and a rate of tax is determined by reference to that notional income; such rate of tax is then applied to the whole taxable income.

**Property partly used for the purpose of producing assessable income**

10.208 Some reference has already been made to the problems of correlating the operation of subss (1A), (1B) and (1C) of s. 56 with the operation of s. 61. Subsections (1A) and (1C) of s. 56 provide for a mechanical method of determining the depreciation allowable where a unit of property is used to produce income, or is installed ready for use, “for part only of a year of income”. Section 61 applies where “the use of any property by the taxpayer has been only partly for the purpose of producing assessable income”. In this case only “such part of the deduction otherwise allowable under s. 54 or s. 59 in respect of that property as in the opinion of the Commissioner is proper” is an allowable deduction. Subsections
Where subsections (1A), (1B) and (1C) of s. 56 and s. 61 are both applicable, there is, prima facie, an irreconcilable conflict in their operations. The conflict will be avoided only if use for the purpose of producing income “for part only of a year of income” is treated as exclusive of use “only partly for the purpose of producing income”. It may be possible to distinguish (i) a situation where for part of a year property is not used, and for another part is used, to produce income, from (ii) a situation where for the whole of the year property is used only partly for the purpose of producing income. But drawing the distinction will be a demanding exercise. *Anderson* (1956) 11 A.T.D. 115 was decided at a time when the subsections had not been added to s. 56. The facts are stated in the case to have involved use of a motor car partly for the purpose of producing assessable income. Presumably the car was at all times during the year held both for private purposes and income derivation purposes in the intention of the taxpayer. It may be possible to assert that the subsections of s. 56 are only applicable when for some part of a year the property was not, in the intention of the taxpayer, held for any purpose of producing assessable income. The resulting distinction between the areas of operation of the subsections of s. 56 and s. 61 may be a useful reconciliation, but it is hardly justified by the language of the sections.

Some aspects of the operation of s. 61 are considered in *Anderson* in relation to s. 59. A valid formation of an opinion by the Commissioner requires him to determine a notional depreciated value on the assumption that depreciation in the years before disposal had been allowed on the basis of use wholly for the purpose of producing assessable income. The Commissioner may then allow a deduction of some part of the deduction that would have been allowable on disposal, had the notional depreciated value been the actual depreciated value. The deduction that would have been allowable may have been limited by the operation of s. 59(4). In this event the deduction allowed by the Commissioner under s. 61 will be some part of the deduction so limited. It will be noted that s. 61 has no relevance
to the determination of the amount of a balancing charge under s. 59. For this purpose s. 59 is alone applicable, and the depreciated value is the actual depreciated value.

10.211 It may be inferred from *Anderson* that where diminishing balance applies in relation to property partly used for the purpose of producing assessable income, a valid opinion formed by the Commissioner will involve the allowance of a part of the deduction that would have been allowable under ss 54 and 56, had the amount of that deduction been calculated by reference to a notional depreciated value, reflecting deductions in earlier years that would have been allowable had the property been wholly used for the purpose of producing assessable income.

**Division 10C and Division 10D of Part III, sections 124ZA–124ZK: deductions for capital expenditure on traveller accommodation, and deductions for capital expenditure on certain income producing buildings**

10.212 Mention has already been made ([10.155] above) of Divs 10C and 10D, which, with the depreciation provisions, achieve substantial coverage in allowing deductions in respect of the costs of wasting structural assets that are tangible. To satisfy Div. 10C there must have been “qualifying expenditure” in respect of the construction of a building or of an extension, alteration or improvement to a building in Australia; such construction must have commenced after 21 August 1979; and such a building must have been for use wholly or principally for the purpose of operating a hotel: s. 124ZB. Division 10D applies to a construction that commenced after 19 July 1982. The criteria in Div. 10D are similar to the criteria in Div. 10C, but Div. 10D extends the scope of deductibility to capital expenditure relating to the construction of all income-producing buildings, except for residential buildings and certain exhibition buildings: s. 124ZG.

10.213 Neither Div. 10C nor 10D refers to depreciation per se, but the method of deduction provided for in both cases amounts to a fixed 2 1/2 per cent prime cost method of depreciation over 40 years: ss 124ZC, 124ZH. The rate is 4 per cent for buildings whose construction commenced after 21 August 1984. There is no provision for loading or acceleration, unlike the regime provided for by ss 54–62. And no deductions are allowed in respect of any property in respect of which depreciation is available under s. 54: ss 124ZB(3), 124ZG(3).

10.214 It has been noted in [10.188]ff. above that s. 59 provides an adjustment by way of balancing charge or allowable deduction where an item of property, to which s. 54 applies, has been disposed of or destroyed. There is no similar provision for adjustments in Div. 10C or Div. 10D. The price that the new owner pays for the building is irrelevant in determining
the depreciation available to him: there is a 40 year depreciation which will not be affected by a change in ownership, provided that new owners use the property for the requisite purposes outlined in Divs 10C and 10D. Similarly, the price the vendor receives will not affect the vendor's tax liability. The policy behind this reluctance to allow balancing adjustments was expressed by the Asprey Committee: “... the difficulty of ensuring a fair and realistic segregation, within the proceeds from the sale of a property, of that part of those proceeds applicable to a building dictates that there be neither a balancing charge nor a balancing allowance” (Taxation Review Committee, *Full Report* (A.G.P.S., 1975), p. 96).

10.215 Sections 124ZE and 124ZK go some way towards providing for the type of adjustments found in s. 59: they provide for a deduction of the “residual capital expenditure”—in effect the notional depreciated value—less the proceeds of insurance or compensation where the building has been destroyed. The effect of ss 124ZE and 124ZK is consistent, to some degree, with the policy recommendations of the Asprey Committee which argued:

“There would need to be exceptions, in the case of demolition or damage to a depreciated building, to the general rule that balancing adjustments are not made. Problems of segregating amounts received between land and buildings would not arise here... In the case of demolition or destruction, the difference between the written down value of the building and the salvage or insurance proceeds would be allowed as a deduction in the year of demolition. If the proceeds exceeded the written-down value, the excess, up to the sum of the depreciation deductions previously allowed to the taxpayer, would be a balancing charge... Where there is only partial damage, any insurance recoveries would be offset against the cost of any restoration not deductible as a repair. Any amount not so absorbed would be treated as a balancing charge to the extent of depreciation previously allowed to the taxpayer... Insurance recoveries in respect of restoration amounting to repair are income under existing law and the repair cost deductible. Balancing deductions would not be allowed, since depreciation will continue to be available on the original schedule” (Asprey Report, pp 96–97).

Curiously, Div. 10C and Div. 10D make no provision for a balancing charge in the case of destruction of a building (or part of a building), even though balancing deductions are provided for. Thus, the only balancing adjustment provided for by Div. 10C and Div. 10D is a balancing deduction where the amount received pursuant to the destruction of a building (or part of building)—under a policy of insurance or otherwise—is less than the residual capital expenditure (or the amount of it attributable to the destroyed part).

10.216 The relationship between ss 124ZE and 124ZK on the one hand and s. 53 on the other hand is not entirely clear. It is presumed that damage subject to repairs contemplated by s. 53 is different from destruction of part of a building contemplated by ss 124ZE and 124ZK. This assumption is
consistent with the view of the Asprey Committee in the latter part of the extract above.

**Section 67: expenses of borrowing**

10.217 Section 67(1) provides for deductions, spread over the period of the borrowing, in respect of expenditure incurred by the taxpayer in borrowing money used by him for the purpose of producing assessable income. The period of the borrowing for this purpose is in some circumstances a deemed period specified in s. 67(2). Where the total expenditure incurred by a taxpayer in a year of income is less than $100, spreading the expenditure over the period of the borrowing is not required: the whole of the expenditure is an allowable deduction in the year of income.

10.218 Section 67(1) is not in its terms limited to expenditure that is not working. Expenditure incurred by a taxpayer in borrowing money could be seen as working expenditure deductible under s. 51(1), at least when the liability to repay is a liability on revenue account. All judges in the Federal Court in *Ure* (1981) 81 A.T.C. 4100 assumed that the costs of obtaining a loan are not working. There may be room for a rethinking of that assumption in view of the decision in *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510 and in particular the abandonment in that case by Gibbs C.J. of a view that a borrowing always gives rise to a liability on capital account. There is at least an awkwardness in saying that a payment to obtain a borrowing to be used in a process of income derivation is not a working expense because it is an expense to obtain an enduring advantage in the form of the accommodation received, and at the same time treating the borrowing as a liability on revenue account so as to allow a deduction of a loss in discharging the liability. A more helpful analysis would say that where money is borrowed on revenue account the costs of obtaining the borrowing are deductible as working expenses. Alternatively, they are outlays in assuming a liability on revenue account and will enter the determination of profit that is income or a loss that is deductible on the discharge of the liability.

10.219 If costs of obtaining a borrowing are deductible in any circumstances under s. 51(1), there will be problems of correlating the operation of s. 51(1) and the operation of s. 67. All judges in the Federal Court in *Ure* (1981) 81 A.T.C. 4100 were able to avoid any such problems. Deane and Sheppard JJ. held that none of the costs—valuation fees, legal costs and guarantee fees—that fell to be considered in relation to s. 67 were working expenses, and all were in fact deductible in the manner allowed by s. 67. Brennan J. held that the guarantee fees, which were...
payable over the period of the loan, were working expenses—expenses of maintaining or servicing the borrowing—and were deductible under s. 51 (1). He held that they were not deductible under s. 67, because they were not expenditure incurred in borrowing money.

10.220 Where s. 51(1) and s. 67 are both prima facie applicable, s. 67 will, presumably, prevail as the more specific provision. If the costs are seen as outlays in obtaining the accommodation comparable with costs of revenue assets and not deductible under s. 51(1), they will be deductible under s. 67 and, in the operation of s. 82(2), will not be subtractable in determining any profit or loss that is income or deductible on the discharge of the liability.

10.221 If the interpretation of the word “used” in s. 67 adopted by the Federal Court in Ure (1981) 81 A.T.C. 4100 is accepted, it will follow that no apportionment is possible under s. 67 so as to deny part of the cost of the borrowing in circumstances like those in Ure, notwithstanding the addition in 1984 of subs. (4) of s. 67. And if s. 67 is a code there will be no possibility of an apportionment under s. 51(1). Section 67(4) will not make an apportionment possible because it operates only where the taxpayer had borrowed money “used by” him only partly for the purpose of producing assessable income. The interpretation given to “used” in Ure requires a conclusion that, in the circumstances of that case, the money has been wholly used for the purpose of producing assessable income. Subsection (4) will be confined to an operation in circumstances where some part of the money borrowed has not been on-lent, or is not in the year of income on-lent, at interest.

10.222 Section 67 raises questions of a requirement of contemporaneity and a requirement of relevance like those raised in relation to s. 53 in [10.27]–[10.30] above, and in relation to s. 72 in [10.38]–[10.39] above. If there is a contemporaneity requirement, the taxpayer may be denied deduction if he has paid the costs of borrowing before the money borrowed comes to be used for the purpose of producing assessable income. The importing of such a requirement is unlikely. Any requirement of relevance might on the face of the section be satisfied if the money borrowed has at any time been used for the purpose of producing assessable income. It may not matter that in the year of income in which an amount becomes otherwise deductible, the money borrowed is no longer used for the purpose of producing assessable income. The view was taken in [6.86]ff. above that s. 51(1) will allow a deduction of an interest cost only if the amount borrowed continues in the year of income to be outlaid for the purpose of deriving assessable income.
Section 67A: expenditure in connection with the discharge of a mortgage

10.223 Under s. 67A a taxpayer who incurs expenditure (not including payments of principal or interest) in connection with the discharge of a mortgage given by him as security for the repayment of money borrowed by him, or the payment by him of the whole or a part of the purchase price of property purchased by him, may be entitled to deduct that expenditure. The whole of the expenditure is deductible if the money or property was used by him “wholly for the purpose of producing assessable income”. Such part of the expenditure as the Commissioner determines is deductible if the money or property was used by him “partly for that purpose”.

10.224 Section 67A is not in its terms confined to allowing deduction of expenses that would not be deductible under s. 51(1). It may have been assumed, in line with the assumption made in *Ure* (1981) 81 A.T.C. 4100 in relation to the expenses of borrowing money, that expenses of repaying a borrowing can never be deductible under s. 51(1). The assumption in *Ure* is questioned in [10.218] above. In the present context it would be said that where the liability to repay the money borrowed, or to discharge the debt owed for the purchase price of the property purchased, is a liability on revenue account, the expenses of discharging the liability are working expenses. *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510 is authority that a loss on the discharge of a liability on revenue account is deductible, and it should follow that other expenses incurred in discharging the liability are deductible. Alternatively these other expenses are of costs of the accommodation received, like the amount paid in repayment of the borrowing, and may go to increase the loss on the discharge of the liability.

10.225 An overlap in the operations of s. 51(1) and s. 67A will not be important unless there is some difference in the deduction allowed. There is at least one difference evident where the money or property was used only partly for the purpose of producing assessable income. Under s. 67A a deduction is allowable of such part of the expenditure as the Commissioner determines. Under s. 51(1) the allowability of a deduction depends on the operation of the words “to the extent to which”, and no discretion is conferred on the Commissioner. There may be another difference. If the interpretation of “used” adopted in *Ure* is accepted, a borrowing in the circumstances of that case will be a borrowing that is wholly used for the purpose of producing assessable income, so that the whole of the expenditure will be deductible. If the deduction is under s. 51(1) only a portion of the expenditure will be deductible: it will be deductible in accordance with the principle applied in *Ure* to the deductibility of the interest.
Section 68: expenses incurred in relation to the taking of a lease or the assignment or surrender of a lease

10.226 Section 68 allows the deduction of expenditure incurred by a taxpayer for the preparation, registration and stamping of a lease, or of an assignment or surrender of a lease, of property that is to be, or has been, held by him for the purpose of producing assessable income. The words of the section must have a wide operation, and will for the most part cover situations where s. 51(1) would not allow a deduction. A lease of property will most often be a structural asset of the lessee, though the possibility that a lease is in some circumstances a wasting revenue asset should not be excluded. If s. 68 and s. 51(1) do overlap, problems of correlation will not arise since each section will have the same operation. At least this is so if s. 51(1) gives an immediate deduction, as clearly s. 68 does, of costs of a wasting revenue asset. This view has been expressed above that the expense under s. 51(1) should be spread over the life of the wasting revenue asset. If there is overlap and a problem of correlation arises, s. 68 will, presumably, prevail as the more specific provision.

10.227 There will be a number of situations within s. 68 where a deduction would not be allowable under s. 51(1) because the expense is not a working expense or is not contemporaneous. Expenses that may be seen as expenses of taking, assigning or surrendering a lease that is not a revenue asset are not working expenses. Expenses of taking a lease, or of the assignment or surrender of a lease, may be deductible under s. 68, if the property is to be used by the lessee, or has been used by the lessee, to produce assessable income. In these situations the contemporaneity principle may exclude deductibility under s. 51(1), even though the lease is a revenue asset of a business carried on by the lessee.

10.228 The circumstances so far considered are all concerned with the deduction of expenses incurred by the lessee. Section 68 in its terms, seems applicable to expenses incurred by the lessor. An expense of the lessor in giving a lease of property that had been used by him to produce assessable income would not be deductible under s. 51(1) because of that use. The expenses of a lessor in relation to the surrender of a lease of property that the lessor proposes thereafter to use to produce assessable income would be denied deduction under s. 51(1), on the ground that it is not contemporaneous with that use, and on the ground that it is not a working expense of that use.

10.229 Section 68 will allow an apportionment of expenditure where the property is to be, or has been, held by the taxpayer only partly for the purpose of producing assessable income. So much only of the expenditure,
as, in the opinion of the Commissioner, is reasonable, is an allowable
deduction. The meaning of “held partly for the purpose” is discussed in
relation to s. 53(3) in [10.27] ff. above.

Section 68A: expenditure in obtaining, or seeking to obtain, for the purpose of
producing assessable income, the grant of a patent, the registration of a design or
the registration of a copyright

10.230 Section 68A allows the deduction of expenditure “in obtaining or
seeking to obtain, for the purpose of producing assessable income,

(a) the grant, or the extension of the term, of a patent for an invention;
(b) the registration, or the extension of the period of registration, of a design; or
(c) the registration of a copyright.”

10.231 The section will allow an immediate deduction of expenses that
might otherwise have been deductible only under the provisions of Div.
10B of Pt III considered in [10.235]–[10.269] below. If deductible under s.
68A, they are, presumably, excluded from deductibility under Div. 10B as
expenses that are not “of a capital nature”, though this is to give those
words a meaning they do not have in other contexts.

10.232 In the application of the section to expenses of “seeking to obtain”,
where the seeking is unsuccessful, there could be no overlap with Div.
10B. But in this aspect, and more widely, s. 68A may overlap with s. 51(1).
If the item of property would be a revenue asset of the taxpayer's business,
expenses of seeking to obtain it would be deductible under s. 51(1). And
the expenses of obtaining the item of property would be deductible if the
asset would be trading stock of the business. Problems of correlation
between s. 68A and s. 51(1) will not arise since both provisions have the
same operation. In any case, circumstances in which the item of property
may be at once a revenue asset and an asset to be obtained for the purpose
of producing assessable income, are not easily imagined, more especially if
the item of property is a revenue asset as trading stock.

10.233 Section 68A will allow an apportionment of expenditure when it
was incurred in obtaining, or seeking to obtain, the grant, extension or
registration only partly for the purpose of producing assessable income. So
much only of the expenditure as, in the opinion of the Commissioner, is
reasonable, is an allowable deduction. As in relation to s. 68, the
interpretation of the word “used” by the Federal Court in Ure (1981) 81
A.T.C. 4100 is, presumably, inapplicable.

Section 70A: expenditure on the connection of mains electricity facilities to land
10.234 Section 70A contains detailed provisions in relation to the deductibility of “expenditure of a capital nature” on the connection of mains electricity facilities to land. The reference to expenditure of a capital nature ensures that there are no problems of correlation with s. 51(1). There could however be problems of correlation with other specific provisions of the Act were it not for subs. (9), which makes s. 70A prevail, displacing the operation of other specific provisions. The deduction under s. 70A is of the whole of the expenditure, though the facilities are only partly for use in carrying on a business for the purpose of producing assessable income.

Division 10B and Division 10BA of Part III, ss 124K-124ZAP: amortisation deductions in respect of items of industrial or commercial property, and special deductions in respect of Australian films

10.235 Reference has already been made to the fact that, generally, the Assessment Act does not allow deductions in respect of the cost of wasting structural assets that are intangibles ([7.10] above). Deductions are however allowable under Div. 10B of Pt III in respect of the costs of items of commercial or industrial property—patents, copyrights and registered designs. Where the costs relate to a “qualifying Australian film”, as defined in s. 124ZAA, the special incentive provisions of Div. 10BA of Pt III apply. These allow an accelerated deduction equivalent to 150 per cent of the expenditure of a capital nature in producing, or by way of contribution to the cost of producing, such a film. Division 10BA and some provisions of Div. 10B modify the operation of Div. 10B in relation to costs of an Australian film. Division 10BA and the modifying provisions of Div. 10B are not considered in what follows, the attention being directed to the provisions of Div. 10B as they operate in relation to items of commercial or industrial property other than eligible Australian films.

10.236 The provisions of Div. 10B broadly parallel the depreciation provisions of the Act considered in [10.130] ff. above, but there are important differences. Allowable deductions under Div. 10B are available in respect of the residual value of the unit of property, residual value involving the subtraction from the cost of the unit of deductions allowed or allowable under the Division. The deductions in this respect parallel the diminishing balance deductions for depreciation, but they are in effect equivalent to the straight line deductions for depreciation, because the fraction of the residual value that is deductible in any year increases as the remaining “effective life” of the property decreases. The “effective life” of the unit of property is a notion corresponding with annual depreciation per centum under the depreciation provisions. But the Commissioner has no
function to perform in determining the effective life of a unit. It is fixed by
the terms of s. 124U.

10.237 “Cost” is defined in s. 124R in a way that may preclude any
possibility that the taxpayer might, save where some specific provision
allows, claim that the value of the unit of property is its cost, where he has
not incurred an equivalent expense in the purchase of the item of property.

10.238 Amortisation deductions under Div. 10B are available in respect of
property used by the taxpayer in the year of income, or in a previous year
of income, for the purpose of producing assessable income, and in this
respect they accord with depreciation deductions. But deductions under
Div. 10B are available in respect of property if it has in an earlier year been
used to produce assessable income, even though there is no use to produce
income in the year of income in which the deduction is claimed. And Div.
10B will be attracted if there is or has been use which is only in part for the
purpose of producing assessable income. There are no provisions in Div.
10B corresponding with subss (1A), (1B) and (1C) of s. 56, and s. 61.

The availability of the amortisation provisions

10.239 The amortisation provisions are available to a person who possesses
rights (“the owner”) as the “grantee or proprietor of a patent . . . granted in
Australia”, as the owner of a copyright subsisting in Australia, as the
owner of a design registered in Australia or as a licensee under such a
patent copyrights or design (s. 124K(1)). They are not available to a person
who possesses rights as the owner of or a licensee under, a trade mark. A
trade mark is not a wasting asset.

10.240 They are available to the person who possesses the rights if he has
used the rights for the purpose of producing assessable income in the year
of income, or in a previous year of income (s. 124L(1)). Once the rights
have been used to produce income, amortisation deductions continue to be
available as long as the taxpayer possesses the rights, whether or not he
continues to use the rights to produce income.

10.241 Amortisation deductions are available to a person who possesses
relevant rights as a licensee. The giving of a licence by the owner of a
patent, copyright or design is a disposal of rights (s. 124V(1)) and,
presumably, is not a use of those rights. It would follow that a taxpayer
who has not otherwise used the rights to produce income, will not be
entitled to amortisation deductions if he gives a license to another in return
for royalties or other receipts that are income. If he has already made some
undoubted use to produce income, the prospect of a denial of amortisation
deductions will not arise.
10.242 Deductions are available to the person who possesses the rights if he acquired them: (1) by being the inventor, the first owner of the copyright or the author of the design; (2) by purchase; (3) by virtue of a disposal otherwise than for valuable consideration by a person who possessed the rights, who was himself entitled to deductions or would have been so entitled had he used the rights for the purpose of producing income; or (4) by virtue of a transmission by operation of law from a person who possessed the rights and was himself entitled to deductions or would have been entitled had he used the rights for the purpose of producing income.

The method of allowance of deductions

10.243 The amount of an amortisation deduction in a year of income is a fraction of the residual value of the property constituted by the rights possessed. The residual value must be divided by “a number equal to the number of whole years in the effective life” of the property as at the commencement of the year of income (s. 124M(1)). No deduction is allowable in a year of income in which the owner (the person who possesses the rights) ceases to be the owner (s. 124M(3)), save where he ceases to be the owner because of the transmission of the property by operation of law (s. 124M(5) (a)) or where the property was purchased or otherwise acquired by the owner for a specified period, and he ceases to be the owner by reason that the specified period terminates (s. 124M(5) (b)).

10.244 “Effective life” is determined by s. 124U. The period is deemed to commence in relation to the owner of a property at the commencement of the year of income during which the owner first used the property for the purpose of producing income, and ends at the end of a year of income. The length of the period will be determined by the time of ending, which, generally, is the time when the property will terminate. In the case of property acquired for a specified period (a licence for a period) the period will end with the termination of that period, if this is earlier than the time of termination of the patent copyright or design to which the property relates. In the case of a copyright the time of ending is 25 years after the commencement of the period, if this time of ending is earlier than the termination of the copyright.

10.245 “Residual value” at any time is determined by subtracting from the cost of the unit of property to the owner the sum of:

(a) any deductions allowed or allowable under the Division in respect of the unit in assessments in respect of income of the owner of a year or years of income which
ended prior to that time; and
(b) the consideration receivable by the owner in respect of any disposal by him of
the unit in part prior to that time (s. 124s(1)).

It will be seen that the proceeds of a disposal in part (a licence given to
another) are “consideration receivable”, save to the extent that the proceeds
have “been included” or are “to be included” in the assessable income of
the owner under any provision of the Assessment Act other than the
Division (s. 124T(3)). It follows that royalties that are assessable income
received under the grant of a license which is a disposal in part, will not go
to diminish the residual value.

10.246 “Cost” is determined by s. 124R. If the owner became the owner by
reason of being the inventor of the invention that is the subject of the
patent, by reason of being the first owner of the copyright or the author of
the design, his cost is, generally, the expenditure of a capital nature
incurred by him before the unit of property came into existence, where that
expenditure was incurred in relation to devising the invention, producing
the work in which the copyright subsists or producing the design (s. 124L
(1)(a) and s. 124R (1)(a)). If an author incurs expenses in research for a
book, his expenses may be expenses of a revenue nature if he has already
commenced a business of authorship. Such expenses are clearly not
“expenditure of a capital nature”, if they are incurred in acquiring a
copyright that will be sold in the course of the business of authorship. They
will be deductible under s. 51(1) as costs of trading stock if the trading
stock provisions apply, or they will be costs of revenue assets that will
enter the determination of any profit that is income or loss that is
deductible. His expenses may however fail to qualify as revenue expenses,
because they are incurred before the commencement of a business of
authorship. It may be asked whether such expenses are “expenditure of a
capital nature”.

10.247 If the taxpayer at all times intended to licence another to publish the
work or to publish the work himself, the expenses are, presumably,
expenditures of a capital nature. There is another possibility. The taxpayer may
have incurred the expenses intending to sell the copyright in the business
of authorship. Subsequently he decides to license another to publish, or
decides to publish himself. There is no room for s. 36. It is not in its terms
applicable even if the item of property is trading stock. The principle in
Sharkey v. Wernher [1956] A.C. 58 may operate and it may give the
taxpayer a deemed cost of the value of the item of property. But that
deemed cost is not made a cost for purposes of Div. 10B by any of the
provisions of s. 124R. None of the paragraphs of s. 124R(1) is applicable.
The taxpayer will need to argue that “cost” for purposes of s. 124s, which
fixes the residual value, will include a deemed cost where an item ceases to be a revenue asset and becomes a structural asset.

**10.248** There is a question of the limiting effect of the phrase “directly in relation to” in s. 124R(1) (a). Problems akin to those explored in relation to “cost” for depreciation purposes are posed. The word “directly” may be held to confine the scope of the “expenditure of a capital nature”, so that the words embrace only “direct” costs as distinct from “on-costs”.

**10.249** There is a qualification in subss (2) and (3) of s. 124R, which may result in the cost being less than the expenditure incurred in relation to deriving or producing the invention, copyright work or design. If the Commissioner is satisfied that the owner was not dealing at arm's length when he incurred expenditure in relation to the supply to him of goods or services, the cost will be the amount of the expenditure of a capital nature that, in the opinion of the Commissioner, would have been incurred by the owner if he had dealt at arm's length with the supplier. In this and in a number of other provisions noted below, Div. 10B deals with planning to give an inflated cost to an item of property. It was seen ([10.184]–[10.186] above) that the depreciation sections did not include fully effective provisions against such planning until 1979.

**10.250** If the owner became the owner by purchase of the unit of property, his cost is, generally, “the expenditure of a capital nature on the purchase of the unit of property” (s. 124R(1) (b) and s. 124L(1) (b)). These words may embrace expenses incurred before the commencement of any process of income derivation. And they will embrace expenses incurred at a time when the taxpayer has formed the intention of licensing another to use the property acquired or the intention directly to exploit the property himself. Where the Commissioner is satisfied that the owner and the person from whom he purchased the property were not dealing with one another at arm's length, the expenditure of a capital nature incurred by the owner on the purchase is deemed to be the value of the unit of property at the time of purchase or the cost of the unit to the person from whom he acquired it, whichever is the less (s. 124R(3)). If the purchase was a purchase of a part of a unit of property, for example a purchase of a license to use the unit of property, and the purchase is not an arm's length purchase, references in subs. (3) of s. 124R to the cost to the previous owner and to value are to be construed as references to such part of that cost or of that value as the Commissioner determines (s. 124R(4)).

**10.251** Where the unit of property was purchased by the owner with other property and no separate value has been allocated to the unit, the expenditure of the owner on the purchase of the unit for purposes of Div. 10B will be so much of the purchase price of the unit and the other
property as the Commissioner determines (s. 124R(5)).

10.252 If the owner became the owner by virtue of the disposal (otherwise than by way of transmission by operation of law) in whole and otherwise than for valuable consideration, the cost of the owner so acquiring will generally be the residual value of the unit in relation to the last preceding owner of the unit immediately before the time of the disposal of the unit (s. 124R(1)(c)(i) and s. 124L(1)(c)). Where the acquisition arises from a part disposal the cost is such part of the residual value in relation to the last preceding owner as the Commissioner determines (s. 124R(1)(c)(ii) and s. 124L(1)(c)). A similar provision operates where the disposal is by way of transmission by operation of law. In this instance however the reference is to residual value less any deductions allowed or allowable in respect of the unit of property in an assessment in respect of income of the last preceding owner of the year of income in which the transmission took place (s. 124R(1)(d) and s. 124L(1)(d)). It will be recalled ([10.243] above) that s. 124M(5) will allow a deduction to the owner in the year in which the transmission takes place, where he ceases to be the owner by virtue of the transmission of the unit by operation of law.

10.253 The cost to the new owner following a disposal otherwise than for valuable consideration or by transmission, will be the residual value in the hands of the previous owner, notwithstanding that the previous owner did not at any stage use the property for the purpose of producing assessable income. The previous owner will have a residual value under s. 124S notwithstanding that he was not at any time “the owner of a unit of industrial property to whom [the] Division applies”, and thus entitled to amortisation deductions under s. 124M. He cannot be an owner to whom the Division applies unless he has used the unit of property for the purpose of producing assessable income (s. 124L(1)). The residual value of the previous owner may have been acquired by him initially as a person who took in a disposal otherwise than for valuable consideration or on a transmission to him. And the residual value of the person from whom he took may have been acquired in the same way. Ultimately, however, residual value must, it seems, be traced to a cost which reflects expenses incurred by a person who devised the invention or produced the copyright or design, or expenses incurred in the purchase of the unit of property. The question whether there may be a cost in circumstances not covered by any of the paragraphs of s. 124R, which would reflect value at the time property becomes a structural asset in a process of income derivation, was the subject of some observations in [10.247] above.

The consequences of disposal or cessation of a unit of property
Sections 124N and 124P deal with the consequences of disposal of a unit of property, or cessation of a unit. They are broadly parallel with the provisions of s. 59 relating to disposal of property subject to depreciation, considered in [10.188]ff. above. They apply only when the owner of the unit of property is a person to whom the Division applies, that is to say he must have used the property for the purpose of producing assessable income.

There may be an item of income, corresponding with what is referred to in s. 59 as a “balancing charge”, where a unit of property is disposed of and the amount of the consideration receivable in respect of the disposal exceeds the residual value of the unit of property in relation to the taxpayer at the time of disposal. Where there is no residual value, the item of income will be the consideration receivable (s. 124P(1)). However, there is a limitation, in s. 124P(3), applicable in both situations, so that the amount of income may not exceed the sum of the deductions which have been allowed or are allowable in respect of the unit under the Division in assessments of income of the taxpayer less the sum of the amounts if any which have under the section been included in the assessable income of the taxpayer of a previous year of income in respect of the unit. There may have been inclusions in assessable income because of part disposals as explained in [10.258] below.

“Consideration receivable” is defined in s. 124T. Where the property is disposed of by sale the consideration receivable is, generally, the sale price less the expenses of the sale (s. 124T(1)(a)). Where the property is sold with other assets and a specified price is not allocated to the property, the consideration receivable is such part of the sale price as the Commissioner determines less such part of the expenses of sale as the Commissioner determines (s. 124T(1)(b)). Where there is a disposal by operation of law the consideration receivable is an amount equal to the residual value of the unit in relation to the owner immediately before the time of transmission (s. 124T(1)(c)). In this last instance, the arising of an item of income is precluded by the equality of residual value and consideration receivable. The assumption in s. 124T(1)(c) that a transmission by operation of law is a disposal, has a bearing on the question, raised in dealing with the depreciation provisions, whether death is a disposal for purposes of those provisions. Transmission by operation of law for purposes of Div. 10B is defined in s. 124K so that it includes transmission on death. Section 124K (3) may however be pointed to as the explanation of the assumption in s. 124T(1)(c). On one view of that subsection it deems a transmission by operation of law to be a disposal. On another view, however, the subsection is simply concerned with identifying
the time at which disposal takes place under a transmission.

10.257 It has already been noted ([10.245] above) that the consideration receivable does not include an amount receivable in respect of the disposal that has been included or is to be included in the assessable income of the owner under provisions of the Act other than Div. 10B.

10.258 These provisions by which an amount may be included in assessable income are applicable to a part disposal. There is a part disposal where a licence is given in respect of a unit of property (s. 124V). Where there is a part disposal and the consideration receivable is less than the residual value of the property, the consideration receivable will go to reduce the residual value of the unit of property (s. 124S(1)). Where the consideration receivable exceeds the residual value, there will be assessable income within the limits set by s. 124P(3). The unit of property which the taxpayer retains after the disposal in part, is deemed to be the same unit of property as the unit of property disposed of in part.

10.259 Section 124N provides for an allowable deduction on disposal in whole of a unit of property or on its ceasing to exist. Where the consideration receivable is less than the residual value there is an allowable deduction of the difference between the consideration receivable and the residual value: s. 124N. Where there is a disposal in part an allowable deduction cannot arise. The consideration receivable is simply set against the residual value (s. 124S (1)).

10.260 Where a unit of property ceases to exist by reason of the patent or copyright, or the registration of the design, ceasing to be in force, the amount of any residual value of the unit of property is an allowable deduction.

10.261 The grant of a licence is a part disposal by the owner of the patent, copyright or design, and the grant could not produce an allowable deduction for the owner. But the licensee is the owner of a unit of property. If he surrenders his licence and there is no consideration receivable in respect of the surrender, the amount of the residual value will be an allowable deduction. If he surrenders “in consideration of the payment to him of an amount”, it seems that he will be taken to have disposed of a unit of property and ss 124P and 124N will apply. This would appear to be the effect of s. 124V (2) (a) in providing that the surrender is not a disposal of the unit “unless the surrender was made in consideration of the payment to him of an amount”. The owner of a unit of property who receives the surrender of the licence is entitled, generally, to an increase in the cost of the unit by an amount equal to the expenditure he incurred in obtaining the surrender (s. 124S(2) (a)). There is however a control on planning to inflate the cost of a unit of property, of the kind already noted in subss (2) and (3)
of s. 124R. By s. 124S(2), if the Commissioner is satisfied that the owner and the person surrendering were not dealing with one another at arm's length, and the consideration given for the surrender is greater than the value of the licence or, if not, it is none the less greater than the expenditure incurred by the person who surrendered the licence, in obtaining the grant of the licence, the cost of the unit of property is increased only by an amount equal to the value of the licence or that expenditure, whichever is the less.

10.262 Section 124T(1), in defining consideration receivable, deals only with disposals by sale and transmission. It does not deal with a disposal for no consideration. Section 124T(2), however, assumes that a disposal without consideration is a disposal to which ss 124N and 124P are applicable. It provides that the consideration receivable is to be taken to be the amount that was the value of the unit of property or part of the unit at the time of the disposal, “if the Commissioner is satisfied, having regard to any connection between the owner and [the other party to the disposal], or any other relevant circumstances, that the owner and that other person were not dealing with each other at arm's length in relation to the disposal”. Presumably, the mere circumstance that there is no consideration for a disposal will not be sufficient to enable the Commissioner to reach a valid satisfaction that the parties were not dealing with one another at arm's length.

10.263 Section 124T(2) is directed more generally against planning to obtain an allowable deduction on disposal. The planning would seek to deflate the amount receivable. Section 124T(2) extends not only to the circumstances considered in the last paragraph but also to a non arm's length transaction in which the amount receivable by the owner in respect of the disposal is less than the value of the unit or part of the unit at the time of disposal. The effect of s. 124T(2) is that the consideration receivable may be taken to be the amount that was the value of the unit or part of the unit at the time of disposal. Section 124T(2) has a similar operation to the provisions of s. 59(4) added to the depreciation provisions in 1979.

10.264 The reconstructed amount of consideration receivable under s. 124T (2) does not necessarily settle the cost of a unit of property for purposes of determining amortisation deductions available to the person to whom the property was sold. Most likely the buyer's cost will be the price under the contract of sale. Where this has been set at an amount less than the value and the Commissioner has acted under s. 124T(2), there is the prospect of what might be thought to be a fall-out. A deduction is denied to the seller and to the buyer of an amount that would have been deductible.
by the buyer had the unit of property been sold to him for its value. Where there is a sale for the value of the item the buyer will be entitled to deductions reflecting that value as his cost, and the sum of the deductions to seller and buyer may exceed the deductions that would have been allowable to the seller had he retained the unit of property for its effective life. There is no provision of the kind included in ss 60(1) and 62(2) in relation to depreciation, whereby the deductions available to a buyer may not exceed the deductions that would have been available to the seller had he retained the property.

10.265 The contrast has already been drawn between Div. 10B, which allows an amortisation deduction in respect of a unit of property owned by the taxpayer that has been used by him for the purpose of producing assessable income, whether in the year of income in which a deduction is claimed or in an earlier year, and the depreciation provisions which allow a deduction only in respect of property used in the year of income in which the deduction is claimed, or in respect of property installed ready for use in that year. The approach of Div. 10B avoids any concern with apportionment when property is in the year of income used only partly to produce income. The apportionment aspects of the depreciation provisions are not without their difficulties. In any case, the idea of an item of property subject to Div. 10B being used partly to produce assessable income may be thought difficult to imagine: it will be said that it is used to produce income or not used at all.

10.266 Section 124w makes provision for a deemed disposal on a change in the ownership of, or in the interest of persons in, a unit of property, where the person or one or more of the persons who owned the unit before the change has or have an interest in the unit after the change. The corresponding provision in relation to depreciation is s. 59AA.

10.267 Section 124W makes detailed provision as to the consideration receivable by the persons who owned the unit of property before the change, and as to the cost of the unit of property for purposes of amortisation deductions by the persons who own the unit of property after the change. The section distinguishes three situations. The first situation contemplates that the agreement in consequence of which the change occurred specifies an amount as the value of the unit of property which is in fact the value of the unit. Presumably, the market value is meant. The old owners are deemed to have disposed of the unit of property at this value. The new owners are deemed to have incurred expenditure on the purchase of the unit of property equal to the value of the property, or the cost of the unit to the old owners, whichever is the less (s. 124W(3)). In this context, in contrast with actual disposal situations, a principle is
asserted that the new owners may not have deductions that would not have been available to the old owners had there not been a deemed disposal.

10.268 The second situation contemplates that the agreement in consequence of which the change occurred has specified an amount as the value of the unit of property which is greater than its value in fact. The old owners are deemed to have disposed of the unit of property for the amount specified, and there may be an item of assessable income derived by them when that amount exceeds the residual value in their hands. The new owners are deemed to have incurred expenditure of the amount of the value in fact or the cost of the unit to the old owners, whichever is the less (s. 124W(4)). Again a principle is asserted that the new owners may not have deductions that would not have been available to the old owners had there not been a deemed disposal.

10.269 The third situation contemplates that the agreement in consequence of which the change occurred has specified an amount as the value of the unit which is less than the value in fact of the unit. The old owners are deemed to have disposed of the unit of property at its value in fact. The new owners are deemed to have incurred expenditure of the amount of that value or the cost of the unit to the old owners, whichever is the less (s. 124W(5)). Again a principle is asserted that the new owners may not have deductions that would not have been available to the old owners had there not been a deemed disposal. At the same time, in contrast with the probable operation of the corresponding provision (s. 124T(2)) applicable to an actual disposal, ([10.264] above), there is no fall-out. The new owners do not have to take the amount specified in the agreement as their cost. In this respect, s. 124W differs in its operation from the corresponding provision, s. 59AA, in regard to depreciation. Where the amount specified in the agreement is less than “market value” (the phrase used in s. 59AA), and less than the depreciated value, s. 59AA(2) substitutes the market value or the depreciated value, whichever is less, as the consideration receivable by the old owners, and the new owners are deemed to have acquired the property at a cost equal to the amount specified in the agreement.

Provisions Displacing the Operation of Section 51(1) in Relation to some Classes of Expenses

10.270 The question has been raised in earlier paragraphs, in regard to a number of specific provisions, whether those provisions may be said to cover a field, and within that field to displace the operation of s. 51(1). The question was raised, for example, in regard to s. 53 relating to repairs ([10.9] above). A specific provision may allow deduction in a way
different from the operation of s. 51(1). It may allow deductions of an expense spread over a number of years, for example s. 67 discussed in [10.217]–[10.222] above, while s. 51(1), it is assumed, allows a deduction of the expense in one year of income. It may make deductibility depend on a discretion given to the Commissioner, for example s. 67A discussed in [10.223]–[10.225] above: no such discretion is given to the Commissioner by s. 51(1). In such circumstances an argument that the specific provisions are a code is stronger. Where the specific provisions do not operate as a code and there is no provision allowing deduction under both s. 51(1) and the specific provisions, s. 82 considered in [10.4]–[10.7] above will apply, and a deduction will be allowed under the provision which in the opinion of the Commissioner is most appropriate.

10.271 Where specific provisions do operate as a code, s. 51(1) is displaced, and the specific provisions belong under the present heading. Attention is now confined to two illustrations of specific provisions displacing s. 51(1), the first illustration, s. 52, depending on an inference that the specific provision is a code and the second, Subdiv. AA of Div. 3 of Pt III, depending on an express provision to that effect. In the first illustration, a determination of the field covered by the code raises issues of considerable importance.

Section 52: loss incurred by the taxpayer in a year of income upon the sale of any property, or from the carrying on or carrying out of any undertaking or scheme

10.272 Section 52(1) provides that any loss incurred by the taxpayer in the year of income upon the sale of any property or from the carrying on or carrying out of any undertaking or scheme, the profit (if any) from which sale, undertaking or scheme would have been included in his assessable income, shall be an allowable deduction. There is a proviso of some importance in determining the field to which the operative provision applies. The proviso denies a deduction, unless the Commissioner otherwise directs, if the taxpayer has failed to notify the Commissioner by the date on which he lodges his first return “after having acquired the property”, that the property has been acquired by him for the purpose of profit-making by sale or for the carrying on or carrying out of a profit-making undertaking or scheme. The Commissioner's power to direct otherwise is subject to a condition that the Commissioner must be satisfied that the property was acquired by the taxpayer for the purpose of profit-making by sale or for the carrying on or carrying out of any profit-making undertaking or scheme. A number of other subsections, added to s. 52 in 1984, provide for the allowance of a deduction for a loss in particular
circumstances that are described by reference to subsections of s. 25A. Section 25A(1), it will be recalled, takes the place in the Assessment Act that formerly belonged to s. 26(a), now repealed. The other subsections of s. 25A extend and refine the operation of s. 25A(1) in ways that are explained in Chapter 3 above. The operation of the subsections of s. 52 added in 1984 have been considered in Chapter 3 above. The present concern is with the operation of s. 52(1), the subsection that prior to 1984 constituted the whole of s. 52, and the extent to which it may constitute a code.

10.273 In a number of places in this Volume an analysis has been adopted which would treat the reference to “loss” in s. 51(1) as intended to embrace a failure of an asset to realise its cost, in circumstances where a surplus on realisation—a profit— would be assessable income. The analysis would also treat the reference to loss as intended to embrace an exchange loss in circumstances where an exchange gain would be assessable income. The allowing of the deduction of losses of the latter kind is now established by a number of decisions of the High Court, most recently AVCO Financial Services Ltd (1982) 150 C.L.R. 510, though little attention is given to an explanation of deductibility by reference to the words of s. 51(1). The deductibility under s. 51(1) of a loss where there is a failure of an asset to realise its cost in circumstances otherwise the same as those in the banking and insurance company cases, or in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106, would not be doubted. In all these illustrations if a profit had resulted, the profit would have been income by ordinary usage and it would have been a recurrent experience of a business. The loss is, at least potentially, also a recurrent experience of the business. It is relevant and, provided it concerns a revenue asset or liability, a working expense. An acceptable rule may thus assert that where there is a continuing business a loss is deductible in circumstances where a profit would have been assessable income.

10.274 The word “loss” in s. 51(1) will cover other circumstances of a negative balance of proceeds over costs. Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355 has confirmed that a profit from an isolated transaction of land development may be income by ordinary usage. No comment is addressed in the case to the deductibility of a loss arising from such a transaction. A rule that a loss is deductible in circumstances where a profit would have been assessable income may, in this instance, be too wide. Granted that the relevance of an expense is not to be determined by a blast-from-the-whistle approach [5.34], there may yet, in some possible events, be difficulty in saying of a loss in a Whitfords Beach situation that it was incurred in gaining or producing the assessable income or was necessarily
incurred in carrying on a business for the purpose of gaining or producing such income. The notion of carrying on a business ought not to be limited to carrying on a continuing business. But whichever limb of s. 51(1) is relied on, the loss, to be relevant, must be an experience in a process from which income might have been derived. The “abortion” of an isolated venture from which a profit that is income may have been derived, will preclude the derivation of income and, equally, preclude the incurring of a deductible loss. None the less, if the carrying out of the plan of development in Whitfords Beach had resulted in a loss, the loss would, it is submitted, have been deductible under s. 51(1). At least it would have been deductible if s. 52(1) does not exclude the operation of s. 51(1) in the facts of Whitfords Beach.

10.275 Section 52(1) aside, the word “loss” in s. 51(1) will extend to a negative balance of proceeds over costs in a transaction that might have generated a profit that is income by force of s. 43—sales in Australia of goods manufactured out of Australia or imported into Australia. A profit in the circumstances covered by s. 43 would be income by ordinary usage. The effect of s. 43 is simply to preclude the operation of the trading stock provisions, and to refine the meaning of cost for purposes of the ordinary usage notion. Section 51(1) will operate to allow a loss in the same way as it operates to allow a loss in a London Australia Investment situation.

10.276 Section 52(1) aside, the word “loss” in s. 51(1) will extend to a negative balance of proceeds over costs in a transaction that might have generated a profit that is income by force of s. 25A(1) (formerly s. 26(a)). The word income in s. 51(1) is not limited to items that are within the ordinary usage notion of income. In [1.30]ff. above there is a rejection of a view that the word “income” in s. 25 is limited to items that are income by ordinary usage, and the view is taken that the reference is to any item that is income by force of the Assessment Act. In [1.43] above there is a rejection of a view that might be thought to have been taken in Harrowell (1967) 116 C.L.R. 607, that the word “income” in s. 47 refers to income by ordinary usage. In each of these instances, there is a view to be rejected. It has never however been suggested that the word income in s. 51(1) is limited to items that are within the ordinary usage meaning of income. In the thoroughly confused logic that bedevils analysis of these issues, it would be said that the phrase “assessable income” used in s. 51(1) precludes any limitation of the meaning of the word income.

10.277 There is none the less a question as to when a loss may be said to be relevant to the derivation of an item that is income under s. 25A(1). Just as in the isolated business venture ordinary usage income situation considered in the last paragraph, the words “in gaining or producing . . . the
assessable income” must be construed in a way that will allow deduction not-withstanding that there is no income from the activity to which the claimed deduction relates, either in the year of income or in any other year. In [5.30] above there is a reference to indications in judicial statement that the definite article in the first limb of s. 51(1) does not give the first limb a more limited operation than the second limb.

10.278 It would be agreed that a loss is not relevant to the derivation of an item that is income under the second limb of s. 25A(1)—profit-making undertaking or scheme—if property is realised in the aborting of the scheme. What is true in regard to a loss in an isolated business venture that might give rise to a profit that is income by ordinary usage—the *Whitfords Beach* situation—must also be true in the lesser isolated venture that might give rise to a profit that is income within the extension of the notion of income that results from s. 25A(1). The question now is whether there is any comparable notion of aborting a first limb transaction—property sold that was acquired for profit-making by sale—so that a loss on sale will not be deductible under s. 51(1). The forsaking of a purpose to resell at a profit will not preclude the derivation of a profit that is income if a profit results from the later sale of property acquired for such a purpose. It may follow that a loss that is relevant and thus deductible is incurred on sale despite the forsaking of the purpose.

10.279 There is a question as to when a loss may be said to be relevant to the derivation of an item that is income under s. 26AAA—property purchased and sold within 12 months—so that, s. 52(1) aside, it will be deductible under s. 51(1). It may, in this situation, be even more difficult to identify a notion of aborting the transaction, than it is in the case of s. 25A(1) first limb.

10.280 In fact there has been no discussion in any authority of the possible operation of s. 51(1) in allowing a loss in any of ordinary usage isolated venture income, s. 25A(1) or s. 26AAA situations. In the case of an isolated business venture ordinary usage income situation, the absence of discussion may not be surprising: it was not till the decision in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 that there was a clear recognition of an ordinary usage isolated business venture income principle. But the issue cannot be avoided.

10.281 It is perhaps not surprising that there has been no discussion in the authorities of the possible deductibility of a loss under s. 51(1) in a s. 25A(1) situation. With some justification, s. 52(1) has been assumed to be a code. It is however surprising that there has been no discussion of the possibility of deductibility of a loss under s. 51(1) in a s. 26AAA situation. The discussion has centred on the availability of a loss deduction under s.
52. The conclusion reached by the Federal Court in *Werchon* (1982) 82 A.T.C. 4332 that s. 52(1) has no application to a s. 26AAA situation, must direct attention to s. 51(1).

10.282 *Werchon* is authority that s. 52(1) has application only to situations where a profit would be income by force of s. 25A(1). The conclusion in *Werchon* is based on the history of s. 25A(1) and s. 52(1). Section 52(1) in an earlier form, was added to the Assessment Act in 1930 at the same time as an earlier form of s. 25A(1) was added. The conclusion is supported by the language of the proviso added by amendment to s. 52(1) in 1941. The proviso may also suggest that s. 52(1) is a code in relation to the deductibility of a loss in such situations. The scope of s. 25A(1) was examined by the High Court in *Whitfords Beach*. The judgments in that case are not definitive, but they may stand for a conclusion that s. 25A(1) has no operation save to extend the notion of income for purposes of the Act beyond what is income by ordinary usage. It would follow that s. 25A(1) has no operation in the circumstances of the banking and life insurance cases, in the circumstances of *London Australia Investment Ltd* (1977) 138 C.L.R. 106 or in the circumstances of *Whitfords Beach*, and that s. 52(1) has no application in those circumstances. Deductibility of losses is left to the operation of s. 51(1).

10.283 The Federal Court in *Werchon* (1982) 82 A.T.C. 4332 did not address itself to the question whether s. 52(1) is a code covering the field of its operation so that s. 51(1) is displaced. The observation of members of the court as to the operation of the proviso may suggest that it is a code. The proviso would be deprived of any function if the taxpayer could call on s. 51(1), unless s. 52 has in some respect a wider operation within the field than s. 51(1) may have. It was suggested above that s. 51(1) may have a test of relevance that does not go as far as s. 52(1), in the latter's application to a situation that would have been within the first limb had a profit resulted. The test under s. 52(1) is simply that the loss was incurred “upon the sale of any property, . . . the profit (if any) from which sale would have been included” in the taxpayer's assessable income.

10.284 There is a difficulty in the way of holding that s. 52(1) is a code. It would be accepted, though there are some observations by Barwick C.J. to the contrary, that the second limb of s. 25A(1) can operate in relation to property that was not acquired for the purpose of carrying out of a profit-making undertaking or scheme. Yet the proviso to s. 52(1) would deny a deduction for a loss in that situation. There would not have been any notice given by the taxpayer, and no valid notice could, presumably, have been given: *Werchon* may support a view that a notice contrary to the facts is a nullity. The Commissioner's power to allow a deduction for the loss in the
absence of notice will not arise. In the circumstances, he could not be satisfied that the property was acquired by the taxpayer for the purpose of carrying on or carrying out a profit-making undertaking or scheme.  

10.285 It may be appropriate to treat s. 52(1) as a code covering a field limited to circumstances where property was acquired with a purpose of the kind described in the proviso, leaving the taxpayer to rely on s. 51(1) in other circumstances.  

Subdivision AA of Division 3 of Part III—sections 82AAA-82AAR: amounts set apart or paid as or to a fund for the purpose of making provision for superannuation benefits for, or for dependants of, an employee or employees  

10.286 Section 82AAC allows as deductions amounts set apart or paid in the year of income by a taxpayer as or to a fund or funds, from which the benefits are to be provided, for the purpose of making provision for superannuation benefits for, or for dependants of, an employee. The employee must be an “eligible employee” as defined in s. 82AAA. The right of the employee or dependant to receive the benefits must be fully secured, and other conditions, including limitations on the amount deductible, provided for in Subdiv. AA must be met. “Superannuation benefits” is defined in s. 6 to mean “individual personal benefits, pensions or retiring allowances”.  

10.287 Section 82AAR expressly makes Subdiv. AA a code governing deductibility of employer contributions to superannuation funds which fall within the field specified in that section. The section provides that “a deduction is not allowable under any provision of this Act other than [Subdiv. AA] in respect of an amount set apart or paid by a taxpayer as or to a fund for the purpose of making provision for superannuation benefits for, or for dependants of, an employee or employees”. The consequence is that, within the specified field, a taxpayer is denied deductibility under s. 51(1). Were it not for s. 82AAR, recurrent payments would, generally, be deductible under s. 51(1). They are relevant as payments directed to securing the goodwill and loyalty of employees. If the payments are required by contracts of service, they may have the same quality of relevance as wages and salaries paid. Any difficulty in establishing deductibility under s. 51(1) is likely to be a difficulty of showing that a payment is a working expense. It will be apparent from British Insulated & Helsby Cables Ltd v. Atherton [1926] A.C. 205 that a substantial initial contribution by an employer to a fund may not qualify as a working expense. It may be seen as securing an enduring benefit. It does not maintain a capacity to provide superannuation benefits to employees, it establishes that capacity. British Insulated & Helsby Cables lends support
to a conclusion that an expense is not a working expense when it is a payment of interest in advance for a significant period, a conclusion considered in [6.117]–[6.118] above.

10.288 When Subdiv. AA applies, the question of degree that arises in separating a deductible payment from a non-deductible payment in the application of the principle in British Insulated & Helsby Cables, is answered in s. 82AAE by imposing money limits on deductible payments, related to the number of employees and the amount of their remuneration, and the giving of a discretion to the Commissioner to allow deductions beyond those limits.

Provisions Denying Deductions otherwise Allowable under Section 51(1)

10.289 Provisions, referred to under the last heading, which establish codes which displace the operation of s. 51(1) are in effect provisions denying deductibility under s. 51(1). The intention under the present heading is to deal with provisions which simply deny deductions which would otherwise be allowable under s. 51(1), without setting up any distinct regime under which the deductions may be allowable.

Section 31C: amounts paid for articles of trading stock

10.290 Section 31C was inserted in the Act at the time of the introduction of provisions directed to allowing a deduction of a percentage of the cost of trading stock on hand at the commencement of a year of income. The deduction, referred to in the heading of Subdiv. BA of Div. 2 of Pt III which provided for the deduction, as “trading stock valuation adjustments”, was intended to achieve some correction of the distortion of profits from the sale of trading stock which may result in inflationary conditions, if the deduction for the cost of stock is limited to the amount of the historical cost. Subdivision BA allowed a further deduction, reflecting, to a degree, the rate of inflation over the relevant year of income. The further deduction was, generally, a percentage of the cost, and the advantage of a high cost in limiting the amount of taxable income from the sale of trading stock was thus increased. Section 31C was intended to defeat planning to give a high cost, thus denying an increased tax advantage that would result from the trading stock valuation adjustment. Trading stock valuation adjustment was withdrawn with effect from 1 July 1979, but s. 31C has been retained as a continuing control on planning to inflate the cost of trading stock. A higher cost will shift taxable income from the purchaser. It may increase the
income of the vendor, but there may none the less be an advantage arising from the fact that the shift of income is to a vendor who is not subject to Australian tax, being a non-resident who does not derive income from an Australian source. New provisions in Div. 13 of Pt III, added in 1981, have made s. 31C unnecessary as the means of denying the latter advantage: s. 31C is now displaced by s. 136AB(2). But s. 31C as a means of denying the advantage of income shifting between Australian residents remains effective.

10.291 Section 31C gives the Commissioner power to reconstruct the price at which trading stock is acquired. The reconstruction will increase the taxable income of the purchaser and decrease the taxable income of the vendor, thus producing the distribution of income between them that would have occurred had no attempt been made to inflate the price. The Commissioner's power arises if he is satisfied that vendor and purchaser were not dealing with each other at arm's length, and is also satisfied that the purchase price is greater than what would have been the purchase price if the parties had been dealing with one another at arm's length, or, alternatively, that the purchaser could have purchased an identical article from another at a price less than the purchase price. The Commissioner's power in effect allows him to substitute for the purchase price either the arm's length price or the price of an identical article, whichever is less.

10.292 Section 31C enables the Commissioner to deny some part of a deduction that Cecil Bros Pty Ltd (1964) 111 C.L.R. 430 appears to hold must be allowed in full. Cecil and subsequent developments from that decision are discussed in [6.6] and [9.17]ff. above. Section 31C will be of less significance if the demise of the form and blinkers approach to the operation of s. 51(1), a demise heralded in the Federal Court decision in Ure (1981) 81 A.T.C. 4100, comes to be confirmed by the High Court. A payment that is, commercially, an over-payment for goods or services, made to an associated person, justifies an objective inference of two purposes in the payment only one of which relates to the derivation of income. To the extent that an inference of a purpose to shift income can be drawn, an apportionment so as to deny the deduction of some part of the payment will be appropriate.

10.293 Section 31C will continue to have some significance: it provides, in its reference to the cost of purchase of an identical article, a more precise test of what is the amount deductible than s. 51(1) may provide. Where the Commissioner acts under s. 31C the taxpayer's action is the more restricted, because he must challenge the exercise of a discretion.

Subdivision B of Division 2A of Part III, sections 50A-50N: denial of deductions
incurred during part of a year exceeding income derived in that part of a year

10.294 Subdivision B of Div. 2A of Pt III was added to the Assessment Act in 1978. Its principal function parallels the function of SS 80A-80F considered in [10.367]–[10.420] below, which are intended to deny the carry forward by a company of a loss, in the sense of an excess of allowable deductions over assessable income, incurred in one year of income so that the loss is applied against assessable income in determining the taxable income of a subsequent year of income, where there has been a substantial change in beneficial interests in shares in the company. Sections 80A-80F have no application where (i) a company in the early part of a year of income incurs deductible expenses which exceed its assessable income derived in that part of the year, and then (ii) suffers a substantial change in beneficial interests in its shares, and thereafter during the remainder of the year of income (iii) derives assessable income that exceeds allowable deductions. Subdivision B, in provisions which have come to be referred to as “current year loss provisions”, has an operation in such a situation which will in effect deny deduction of otherwise deductible expenses, so far as they exceed assessable income of the early part of the year, in computing the taxable income of the year of income.

10.295 Subdivision B is a further expression of the policy against the sale of shares in companies that have suffered losses, losses in the sense of an excess of allowable deductions over assessable income, a policy that was and remains expressed in SS 80A-80F. An individual engaged directly in a process of income derivation who has suffered losses cannot sell the losses to another and thus realise the value of the tax relief that the application of those losses may bring. A shareholder engaged through a company in which he holds shares in a process of income derivation ought not to be able to realise the value of losses experienced by the company by selling his shares in the company.

10.296 The current year loss provisions extend not only to the indirect realisation of losses by the sale of shares in a company that has already experienced losses in the early part of a year of income, but also to an indirect realisation of the potential for the application of losses that may be incurred in the latter part of a year of income where the company has made profits in the early part of the year. Selling shares in a company which has an excess of assessable income over allowable deductions in the early part of the year of income is a realisation of that potential. The provisions of SS 80A-80F do not need to deal with the latter situation since, it will be seen, the Australian law does not allow the carry-back of a loss incurred in a later year to a year in which there was a surplus of assessable income over
allowable deductions. The idea that there may be value in the shares of a company because the profits so far earned in a year of income may be absorbed by the losses that may arise under new owners of the shares, may be thought remote. The value is likely to depend on the ease with which the new shareholders can bring about a loss experience by the company in the latter part of the year of income, by creating deductions which do not in fact reflect expenses which diminish the resources of the company. Tax planning in the second half of the 1970s was characterised by “expenditure recoupment” schemes which were directed to establishing such deductions. Such schemes are now the subject of specific anti-avoidance provisions of the kind noted above in connection with s. 78(1)(a), and noted further in dealing with SS 82KH, 82KL and 82KJ.

10.297 Central to the operation of Subdiv. B is the occurrence during a year of income of a “disqualifying event”. A disqualifying event is:

(i) a change in beneficial ownership of shares in the company carrying between them the right to exercise more than one-half of the voting power in the company, or the right to receive more than one-half of any distribution of capital in the company;
(ii) a change in control of the voting power in the company, where those acquiring control did so for the purpose of receiving any benefit in relation to the application of the Act or securing that another person or other persons would receive such a benefit or obtain such an advantage; or
(iii) an event that involves the deriving of income in order that it might be absorbed by expenses already incurred, or the incurring of expenses in order that they might absorb income already derived; or
(iv) an event that involves a person other than the company deriving a benefit or obtaining an advantage from the operation of the Act as a result of an agreement or understanding entered into before the event that would not have been entered into if the company had not had an available loss or an available profit immediately before the event; or
(v) an event that involves the affairs or business operations of the company being managed or conducted without proper regard to the rights, powers or interests of a natural person or persons who controlled the voting power in the company at the time (s. 50H(1)).

The occurrence of such an event will require that a year of income be treated as divided into “relevant periods” (s. 50B), whose limits are set by the beginning of the year of income, the disqualifying event and the end of the year of income. There will be more than two periods if there is more than one disqualifying event during the year of income. A calculation is made of assessable income and allowable deductions of each period. If the assessable income exceeds allowable deductions, the company in that period (an “income period”) has a notional taxable income. If allowable deductions exceed the assessable income of the period (a “loss period”), the company has a notional loss. There is provision for spreading some items of income and deduction over the year of income so that they will fall to some degree in each period.
Some other items do not enter the calculation of notional taxable income of a period, or notional loss of a period. These “full year amounts” enter the final calculation of taxable income of the year of income (s. 50C). In that final calculation a notional loss will not be subtractable unless it has been taken into account in ascertaining the “eligible notional loss” (s. 50D). It will be an eligible notional loss to the extent of the amount of the notional taxable income of an income period if there is a continuity of beneficial ownership at all times in the loss period and at all times in the income period, within the tests in s. 50D(2), but a notional loss will not enter eligible notional loss if the loss period commenced with a disqualifying event or the income period commenced with a disqualifying event of the kinds set out in events (ii), (iii), (iv) and (v) above (s. 50D(3)).

10.298 Though the drafting is involved, the effect would appear to be that a notional loss may enter “eligible notional loss” because of a continuity of ownership where there have been two disqualifying events involving discontinuities, if there is a continuity between the first period and the last period.

10.299 A discontinuity of beneficial ownership of shares or a change in control will not preclude a notional loss entering eligible notional loss, in the manner specified in subss (4) and (6) of s. 50D, if there has been a continuity of business of the kind specified in those subsections. But continuity of business will not enable a notional loss to enter eligible notional loss if the loss period commenced or the income period commenced with a disqualifying event within events (iii), (iv) and (v) in [10.297] above (s. 50D(9)).

10.300 The tests of continuity of beneficial ownership in s. 50D(2) and of a change in beneficial ownership in paras (a), (b) and (c) of s. 50H are adapted from the provisions of s. 80A. Section 50K adopts the provisions of s. 80B, including s. 80B(5), for the purposes of the operation of s. 50D (2) and s. 50H. Sections 80A and 80B(5) are the subject of some comment in [10.375]ff. below. The concept of continuity of business follows the same concept in s. 80E. Section 80E is the subject of some comment in [10.399]ff. below. The significance of continuity of business is less under the current year loss provisions than under the loss carry forward provisions in that it cannot overcome disqualifying events at the commencement of the loss period or the income period. Though the drafting of SS 80E and 80DA is not entirely clear on the matter, it seems that a continuity of business will prevent the defeat of loss carry forward that would otherwise result from s. 80DA, a section which has functions similar to the disqualifying events listed in events (ii), (iv) and (v) in [10.297] above (s. 50H(1) (e), (f), (g) and (h)).

Section 51AB: expenses incurred to secure or maintain membership of a “club”, or facilities provided by a club, and expenses incurred in connection with a “leisure
The operation of s. 51AB in denying deductions in respect of expenses of securing or maintaining membership of, or rights to enjoy facilities provided by a “club”, as defined in s. 51AB(1), was the subject of some comment in [6.261] above.

The same section denies deductions of expenses incurred for or in connection with (i) the acquisition of ownership of, or rights to use, a “leisure facility”, (ii) the retention of ownership of, or of rights to use, a “leisure facility”, (iii) any obligation associated with ownership of, or rights to use, a “leisure facility”, or (iv) the use, operation, maintenance or repair of a “leisure facility”. “Leisure facility” is defined in s. 51AB(1) so that it means, save where the item is an “excepted facility”, a boat, land used or held for use for or in connection with holidays or sport, recreation or similar leisure-time pursuits, or a building or other structure used or held for use in that way. “Excepted facility” is defined in s. 51AB(1). The effect of the latter definition is to prevent the denial of a deduction where the item is held for sale or is used or held for use in specified ways. In the case of a boat, the uses that are specified are (i) letting on hire in the ordinary course of a business of such letting, (ii) transporting for reward members of the public, goods or substances in the ordinary course of business; and (iii) use that the Commissioner is satisfied is essential to the efficient conduct of the taxpayer's business. In the case of land, buildings and structures, the uses that are specified are (i) the derivation of income in the nature of rents, lease premiums, licence fees or similar charges; (ii) the provision for reward of facilities for holidays, or for sport, recreation or similar leisure-time pursuits in the ordinary course of a business of providing such facilities; and (iii) the provision, for use principally by employees of the taxpayer or for the care of children of those employees or, where the taxpayer is a company, for use principally by employees of the company who are not members or directors of the company or for the care of children of those employees, of facilities for holidays or for sport, recreation or similar leisure-time pursuits.

Where the expense is incurred by a taxpayer in connection with a leisure facility for his own use, deductibility under s. 51(1) would raise issues of relevance and working character of the expense that the taxpayer might find difficulty in having resolved in his favour, the more so where the taxpayer is an employee. Where he invites others—clients, customers or shareholders—to use the facility, there would be some prospect of relevance as expenses in furthering the goodwill of the business. The policy in denying deduction is to establish a firm rule against the taxpayer
that will prevent the taxpayer enjoying a tax subsidy for what is in truth expenditure on his own recreation, and may discourage him from providing recreation for customers, clients and shareholders that will be tax free to them. Where the expenses are incurred by an employer in providing leisure facilities for employees or, in the case of a company, for its directors, relevance and working character under s. 51(1) would most likely be resolved in favour of the taxpayer: the expenses may be seen as expenses of providing conditions of service for employees or directors or rewarding them for their services. The denial of deductions by s. 51AB is in this area the more significant. The policy in denying the deduction is apparently to achieve some control over the provision of what may be in fact tax-free fringe benefits enjoyed by employees and directors. There would be difficulty in taxing the employee or director under s. 26(e) on the value to him of the facility: there is a prospect that the facility would be characterised as a condition of service and not a reward for services. However, in denying deductions to the employer, s. 51AB leaves the prospect that the employee or director may be taxed on the value of the facility, while the employer is denied a deduction of its cost.

10.304 The policy of controlling tax-free fringe benefits becomes attenuated by that element in the definition of “excepted facility” (para. (e) (iii)) which refers to “the provision, for use principally by employees of the taxpayer or for the care of children of those employees or, where the taxpayer is a company, for use principally by employees of the company who are not members or directors of the company or for the care of children of those employees, of facilities for holidays or for sport, recreation or similar leisure time pursuits”.

10.305 Where s. 51AB operates, a deduction is denied under s. 51(1). There is an associated provision in s. 54(3) which denies a deduction for depreciation on property that is a leisure facility as defined in s. 51AB.

Section 52A: expenditure incurred by a taxpayer in the purchase or acquisition of choses in action as trading stock, or in the purchase or acquisition of property purchased or acquired in the carrying on or carrying out of a profit-making undertaking or scheme

10.306 Section 52A may empower the Commissioner to deny a deduction, to the extent that he considers that the amount is unreasonable, where it relates to expenditure incurred by a taxpayer in the purchase or acquisition of choses in action purchased or acquired as trading stock, or in the carrying out of any profit-making undertaking or scheme (s. 52A(1) (2)). The section may also empower the Commissioner to deny a deduction or the subtraction of a cost, that is claimed in respect of the value of a chose
in action that has been acquired by a taxpayer and thereafter is treated by the taxpayer as an asset of a business carried on by the taxpayer, or is used by the taxpayer in the carrying on or carrying out of a profit-making undertaking or scheme (s. 52A(2A (2B)).

10.307 In the latter aspect s. 52A gives statutory recognition to a principle that the value of an asset may be the cost of the asset for purposes of the trading stock provisions, or in determining the profit that is income on the realisation of an asset. Some reference has already been made to this principle, and it is the subject of further observations in Part III of this Volume.

10.308 The effect of s. 52A is that the Commissioner may deny a deduction or the subtraction of a cost, even though the expenditure or the cost reflects the value of the chose in action at the time it is acquired as trading stock or becomes trading stock, or at the time it is acquired in the carrying on or carrying out of a profit-making undertaking or scheme, or comes to be used in carrying on or carrying out such a scheme. The section was added to the Act in 1978 and its operation extended in 1979 to enable the defeat of tax planning that involved the creation of losses in transactions by which choses in action—principally shares—were acquired and thereafter made to suffer a substantial reduction in value. In the case of shares, the reduction in value might be achieved by a payment of dividends on other shares, or the making of a bonus issue confined to other shares. The shares reduced in value would be sold at a loss. In exercising his power to allow only a deduction or a cost of an amount that he considers reasonable, the Commissioner is directed by subs. (3) to have regard to a number of matters. The matters identify aspects of the tax planning at whose defeat the section is directed.

10.309 There is no provision of s. 52A that requires the Commissioner to treat the amount of the cost allowed as a deduction, or taken into account in computing a profit, as the amount of the proceeds of the sale by the person from whom the taxpayer acquired the chose in action. Section 31C, considered in [10.290]ff. above, makes the amount ascertained under the section the purchase price “for all purposes of [the] Act in relation to the purchaser and the vendor” (s. 31C(1)).

Section 65(1): payment made or liability incurred by a taxpayer to an associated person

10.310 Section 65 empowers the Commissioner to deny a deduction that would otherwise be allowable, where there is a payment made or a liability incurred by a taxpayer to an “associated person”. The power given by subs.
(1) is to deny the deduction to the extent to which the payment or liability, in the opinion of the Commissioner, is not reasonable. “Associated person” is defined in s. 65(1D). In all aspects of the definition a notion of “relative”, defined in s. 6, has a role.

10.311 In one respect s. 65 differs from s. 52A just considered, and from a number of other provisions yet to be considered, in particular ss 82KJ and 82KL, which provide for the disallowance of a deduction but leave the transaction intact so far as the tax consequences for the person receiving the payment are concerned. Section 65(1A) provides that, subject to s. 65 (1B), where, by virtue of subs. (1) any amount is not an allowable deduction “that amount shall, for the purposes of the Act, be deemed not to be income of the associated person”. The effect of subs. (1B) is to qualify the operation of s. 65(1A): where the deduction denied is a deduction otherwise allowable in computing the net income of a partnership in which a private company is a partner, the company partner is deemed to have paid a dividend of an amount ascertained in accordance with subs. (1C), and subs. (1A) is excluded. The deeming is, it seems, for the purposes of determining the consequences of the payment for the company partner, for example in relation to undistributed profits tax, and for the purpose of determining the consequences for the person receiving the payment. He is deemed to have derived as a dividend the amount ascertained in accordance with subs. (1C).

10.312 There are no guidelines set out in the section governing formation of an opinion by the Commissioner. In this respect the section differs from s. 52A. Presumably, an amount is unreasonable if it is greater than the amount one would have expected to be paid, had the parties to the payment not been associated. It would follow that, having regard to the findings of fact by the trial judge in Phillips (1977) 77 A.T.C. 4169; (1978) 78 A.T.C. 4361, the Commissioner could not have denied deductions in the circumstances of that case, if the section had been available to him. The payments were, in the conclusion of the judge, such as might have been made in arm's length transactions. Section 65 is not attracted when a person who must put a profit into the hands of another, chooses to put it into the hands of an associated person.

10.313 Section 65, it has been explained, is one of a number of provisions by which a deduction may be denied. The relationships between these provisions are not always apparent, though any priority of application that must be accorded to one of them over another may have significant tax implications. Thus the denial of a deduction under s. 65 will be of a lesser amount than the denial of a deduction under s. 82KJ, which must deny the deduction of the whole of an outgoing. And the denial of a deduction under
s. 65 will, generally, diminish the amount that is income of the taxpayer receiving the payment. The denial of a deduction under s. 82KJ has no effect on the income of the taxpayer receiving the payment.

10.314 Section 51AB, considered in [10.301]–[10.305] above, clearly has an application that can leave no room for the application of any other provision. By s. 51AB(4) the denial of a deduction is “notwithstanding anything in any other provision of [the Act]”. Section 51 (1) itself in applying an apportionment may be said to deny a deduction. Other provisions, as far as they operate at all, will operate on what is otherwise deductible under s. 51 (1).

10.315 Sections 82KL and 82KJ have no priority over ss 52A, 65, 108 and 109. As between themselves, s. 82KJ has priority over s. 82KL. Sections 52A, 65, 108 and 109 have priority over s. 82KJ because s. 82KJ may deny a deduction only of a “loss or outgoing in respect of which a deduction would, but for this subdivision [Subdivision D being ss 82KH-82KL] be allowable” (s. 82KJ(a)). Section 82KJ has priority over s. 82KL because s. 82KL is concerned only with “relevant expenditure”, as defined in s. 82KH, which is in all instances expenditure which would be allowable apart from s. 82KL. If the High Court is persuaded to overrule Cecil Bros Pty Ltd (1964) 111 C.L.R. 430—Phillips (1978) 78 A.T.C. 4361 and Ure (1981) 81 A.T.C. 4100 may be heralds of such an event—a taxpayer may be glad that his deduction is partially denied under s. 51, for he is not then at risk to a disallowance of the whole outgoing under ss 82KJ or 82KL.

10.316 The intention of s. 177B (3) and of s. 177B (4), when read with the definition of “tax benefit” in s. 177C, is that other provisions of the Act which may deny a deduction will operate in priority to Pt IVA, But Pt IVA, unlike ss 82KJ and 82KL, may, in theory, operate to deny a deduction of that part of an outgoing which has survived the operation of other provisions. Section 177C (1) is concerned with a situation in which a deduction (not an outgoing) is allowable, which would not have been allowable if the tax avoidance scheme had not been entered into or carried out. Pt IVA has an operation similar to s. 65 in providing, in s. 177F (3), for a compensating adjustment to the income of a taxpayer where a deduction has been denied to another taxpayer under s. 177F (1). There is however this difference that the operation of s. 177F (3) depends on the exercise of a discretion by the Commissioner. The operation of s. 65 (1A) in providing for a compensating adjustment is automatic on the operation of s. 65 (1).

10.317 There is a question whether the taxpayer can require the Commissioner to exercise a discretion given to him by a provision that has priority, for example s. 65, where the exercise of the discretion so as to
deny the deduction of part of an amount will exclude the operation of another provision, for example s. 82KJ, that would deny the deduction of the whole of an amount. A payment to which s. 82KL would otherwise apply because of a recoupment arrangement, may have been made to a relative. The taxpayer may prefer the partial denial of a deduction under s. 65 to the total denial under s. 82KJ.

10.318 Section 65 (1) applies to a “payment made or liability incurred” in the year of income to an associated person that would, but for the subsection be an allowable deduction. Its operation is to allow a deduction only to the extent to which, in the opinion of the Commissioner, the payment made or liability incurred is reasonable. Inferentially the operation is to deny a deduction to the extent to which in the opinion of the Commissioner the payment made or liability incurred is not reasonable. “Associated person” is defined in s. 65 (1D) in terms that distinguish the application of the section “to a taxpayer” (s. 65 (1D) (a)), and the application of the section “to a partnership for the purpose of calculating in accordance with section 90 the net income of the partnership or a partnership loss”.

10.319 It may help to further an understanding of the scope of the operation of s. 65 (1) to ask a number of questions. In what circumstances, if any, will s. 65 (1) apply to a payment or a liability incurred:

(i) by an individual who is not a trustee;
(ii) by a company that is not a trustee;
(iii) by a trustee acting as trustee; and
(iv) by a partnership?

Payment by an individual who is not a trustee

10.320 A payment by an individual taxpayer who is not a trustee to a person who is his relative, as defined in s. 6, is within the operation of s. 65 (1). The relative is an associated person (s. 65 (1D) (a) (i)). And a payment by such an individual taxpayer to a partnership, a partner in which is his relative, is within the operation of s. 65 (1). The partnership is an associated person (s. 65 (1D) (a) (ii)). “Partnership” has the meaning given to it by the definition in s. 6, which is wider than its ordinary meaning in extending to persons in receipt of income jointly.

10.321 The propositions in the last paragraph may require qualification where the person to whom payment is made, though he is a relative of the individual taxpayer, receives the payment as trustee, or where the relative who is a partner in the partnership receiving payment is a trustee. It is
arguable that the policy of s. 65 (1) is not attracted in these circumstances. Save where the trustee has a beneficial interest in the trust, or where another relative has a beneficial interest, the operation of s. 65 (1) would be fortuitous.

10.322 A payment by an individual taxpayer who is not a trustee to a company in which a relative of the taxpayer is interested is not within the operation of s. 65 (1). The company is not an associated person. It could not be argued that a payment to a company is a payment to a person interested in the company.

10.323 A payment by an individual taxpayer who is not a trustee to a trustee of a trust in which a relative of the taxpayer is a beneficiary is not within the operation of s. 65. It is assumed that the trustee is not a relative. It could not be argued that a payment to a trustee is a payment to a beneficiary, more especially when the trust is a discretionary trust.

Payment by a company that is not a trustee

10.324 A payment made directly by a company that is not a trustee cannot attract the operation of s. 65 (1). The company may be a taxpayer but the payment is not made to an associated person. A company cannot have a relative. In these circumstances, there may be an operation of s. 108 or s. 109, considered in [10.348]–[10.358] below. A payment made by a partnership in which a company is a partner will be within the operation of s. 65, if the person (not being a partner in the partnership) to whom payment is made is or has been, or is a relative of a person who is or has been, a shareholder in, or a director of a company being a private company, in relation to the year of income, that is a partner in the partnership. The person to whom payment is made is an associated person (s. 65 (1D) (b) (iii)). In these circumstances there will, presumably, be no operation of ss 108 or 109. Crowe (1958) 100 C.L.R. 532 may be authority that a payment by a partnership is not a payment by a person that is a member of that partnership, though the case can be explained on the basis that the words of s. 82H with which it was concerned—“amounts paid by the taxpayer as premiums or sums for insurance on the life of the taxpayer—are more specific than the words of s. 108 or s. 109. Where s. 65 (1) does apply to a payment made by a partnership in which a company is a partner, the consequences are a denial of a deduction to the extent that the payment is not reasonable, and the further consequences specifically determined by s. 65(1B). The company is deemed to have paid, on the last day of the year of income, a dividend of an amount ascertained in accordance with s. 65(1C), and subs. (1A), which in other circumstances takes the amount denied
deduction out of the income of the person receiving payment, has no application. The effect of s. 65(1B) is, it seems, to require that the amount denied deduction should be treated as a dividend paid by the company, with the consequences that it may satisfy an obligation to distribute so as to prevent a liability to undistributed profits tax, and should be treated as a dividend received by the shareholder or relative. The latter effect may appear to follow from s. 65(1B)(b), though it is not dictated by that provision. Though the amount denied deduction is deemed to be a dividend received by the shareholder or relative, it does not necessarily follow that it is his income. Rutherford (1976) A.T.C. 4304, a decision on s. 108, is authority that deeming a receipt to be a dividend does not make the receipt income. It will be income, by force of s. 44(1), only if it was in fact paid “out of profits” of the company.

Payment by a trustee acting as trustee

10.325 It is arguable that a payment made directly by a trustee acting as trustee cannot be within the operation of s. 65(1). Section 65(1D)(a), which alone is relevant in that subsection, contemplates a payment by a “taxpayer”. It is true that the calculation of net income of a trust estate required by s. 95 is made “as if the trustee were a taxpayer”. Yet the fact that the person to whom payment is made is a relative of a trustee who is an individual should not, as a matter of policy, attract the operation of s. 65 (1). Policy might require the operation of s. 65(1) where the person to whom payment is made is beneficially interested in the trust, but this is not enough to raise an associated person relationship within s. 65.

10.326 Similar observations might be made where the payment is made to a partnership, a partner in which is a relative of a trustee who is an individual.

Payment by a partnership

10.327 Reference was made in [10.324] above to the decision of Kitto J. in Crowe (1958) 100 C.L.R. 532. Section 65(1D)(b) is intended to overcome in specific situations the effect of a conclusion from that decision that a payment by a partnership is not a payment by a member of the partnership. In overcoming the effect of such a conclusion in specific situations, s. 65 (1D)(b) may be thought to have confirmed that conclusion in its application to other situations. It will be seen that this could be of some importance in regard to the operation of ss 108, and 109. In dealing with specific situations, subparas (i) and (ii) of s. 65(1D)(b) establish an associated person relationship where a payment is made by a partnership to
a relative of a partner in the partnership, or to another partnership a partner in which is a relative of a partner in the partnership making the payment. The relationship is established for the purpose of calculating, in accordance with s. 90, the net income of the partnership or a partnership loss. The assumed need for the express provision in s. 65(1D) (b) (ii) to deal with a payment to another partnership, a partner in which is a relative of a partner in the partnership making the payment, may be thought to confirm an inference from the decision in *Crowe* that a payment to a partnership is not a payment to a person who is a member of that partnership. There are again implications for the operation of ss 108 and 109, and in this instance for the operation of s. 65 itself. Section 65(1D)(b) (iii) establishes an associated person relationship where a payment is made by a partnership to a person who is or has been, or is a relative of a person who is or has been, a shareholder in, or a director of, a company, being a private company in relation to the year of income, that is a partner in the partnership. There is no express provision of the kind that appears in s. 65(1D)(b) (ii), which would make a payment to a partnership in which a person of the kind described in s. 65(1D) (b) (iii) is a member, a payment to that person. Section 65(1D)(b) (iv) establishes an associated person relationship where a payment is made by a partnership to a person who is, or is a relative of, a beneficiary in a trust estate the trustee of which is, in his capacity as trustee of the trust estate, a partner in the partnership. It is curious that there is no provision in s. 65(1D) establishing an associated person relationship where a payment is made by a trustee of a trust estate to a person who is, or is a relative of, a beneficiary in the trust estate.

Section 65(2): expenditure incurred and payments becoming due, by the taxpayer in the year of income in or for the maintenance of his wife or any member of his family under the age of 16 year

10.328 Section 65(2) denies a deduction of expenditure incurred and payments becoming due, by the taxpayer in the year of income in or for the maintenance of his wife or any member of his family under the age of 16 years. Deduction is denied even though the expenditure and payments becoming due were incurred in the production of assessable income. The denial of a deduction in circumstances where the expenditure or payments were not incurred in the production of assessable income seems unnecessary, having regard to the terms of s. 51(1). Where the expenditure or payments were so incurred—most likely they will be rewards for services rendered by the wife or child to the taxpayer in relation to the carrying on by him of a business—it is not obvious why deduction should be denied. If the amounts are not reasonable, s. 65(1) will to this extent
operate to deny deduction. If the amounts are reasonable and are income of the wife or child, there seems to be no reason to deny deduction because amounts have been applied by the wife or child in maintaining himself, or have been applied by the taxpayer in maintaining the wife or child. There may be reason to deny a deduction if the provision of maintenance by the husband is not to be regarded as a benefit within s. 26(e) received by the wife or child, so that there is a prospect of a deduction being available to the husband and no income derived by the wife or child. It is perhaps arguable that the receipt by the wife or child of what the taxpayer would be required to provide in any case because of his duty to support, is not a benefit. Such a view of s. 65(2) would confine the operation of the subsection to circumstances where the application is made by the taxpayer. There is reason in the words of the subsection—“expenditure incurred by the taxpayer in or for the maintenance”—for such a view. It would be appropriate for the subsection to include an express provision of the kind that appears in s. 65(1A) in relation to the operation of s. 65(1), so that there will not be income derived by wife or child where a deduction is denied to the husband taxpayer.

Section 82A: expenses of self-education in a year of income not exceeding $250

10.329 Section 159U provides for inclusion of “expenses of self-education”, as defined in that section, in concessional rebate expenditure that may attract a rebate of tax under s. 159N. The amount that may be treated as a rebatable amount is limited by s. 159U(3) to $250. By s. 82A, expenses that are within the definition of expenses of self-education are, to the extent of the first $250, denied deduction under s. 51(1) and must be dealt with as rebatable amounts. Whether they will, as rebatable amounts, generate any actual rebate of tax depends on there being a total of rebatable amounts in the year of income exceeding $2,000 (s. 159N). The deductibility under s. 51(1) of expenses that may be expenses of self-education is dealt with in [8.38]–[8.56] above, where further reference is made to s. 82A.

Subdivision D of Division 3 of Part III (sections 82KH–82KL): losses and outgoings incurred under certain tax avoidance schemes

10.330 The present concern is with ss 82KJ and 82KL. Section 82KK does not operate to deny a deduction outright. It affects only the timing of a deduction and is considered in [11.284]ff. below.
10.331 Sections 82KJ and 82KL, if they operate at all, deny a deduction of the whole amount of an item of expenditure. They differ in this respect
from s. 65 which provides for a partial disallowance.

10.332 The relationship between ss 82KJ and 82KL and other specific provisions denying deductions was the subject of some observations in [10.313]–[10.318] above. Thus, s. 65 will be applicable in advance of ss 82KH and 82KL, and if it is applied, the applications of s. 82KH and s. 82KL will, in effect, be precluded. The part of an expense that is deductible after the operation of s. 65, the Commissioner having formed the opinion that it is to this extent reasonable, will be relevant expenditure for purposes of s. 82KL. But there could not be said to be an additional benefit obtained “in relation to that relevant expenditure”. The additional benefit will have been obtained in relation to the part of the expense that has been denied deduction under s. 65. For similar reasons, where s. 65 operates the operation of s. 82KJ will be precluded.

10.333 Sections 82KJ and 82KL were added to the Assessment Act to deal with tax planning through so-called “expenditure recoupment” schemes, which relied on Cecil Bros Pty Ltd (1964) 111 C.L.R. 430, and South Australian Battery Makers Pty Ltd (1978) 140 C.L.R. 645 and the form and blinkers approach to the operation of s. 51, and to the operation of other sections allowing deductions. That approach is discussed in [9.17]–[9.26] above. That the approach is destructive of the integrity of the income tax is reflected in the involved and complex provisions that have been adopted to overcome it. These provisions will become unnecessary if the approach comes to be rejected. Indeed they will have no room to operate. The operation of s. 65 already precludes the operation of ss 82KJ and 82KL. The denial of part of an outgoing under s. 51(1) because it was to this extent not incurred in gaining assessable income will have the same consequence.

10.334 Since the enactment of ss 82KJ and 82KL, the form and blinkers approach has become not an advantage but a hazard for the tax planner. Full deductibility under s. 51 may let in ss 82KJ and 82KL, which will deny any deduction. If form and blinkers are rejected in circumstances such as in South Australian Battery Makers, and an outgoing held deductible only in part under s. 51(1), the taxpayer will be entitled to some deduction. If ss 82KL and 82KJ are let in because the whole outgoing is deductible under s. 51(1), the taxpayer may be denied any deduction. Sections 82KJ and 82KL have in effect an operation by way of penalty.

10.335 Section 82KJ was enacted before s. 82KL, though in the same year. Section 82KJ is an apparent legislative response to the actual decision in South Australian Battery Makers. In fact the section may not operate in the particular circumstances of that case. Gibbs A.C.J. noted in his judgment that the amount of the payment was reasonable as a payment for the use of
the premises. One of the conditions of the operation of s. 82KJ is that the outgoing “was greater than the amount . . . that might reasonably be expected to have been incurred, at the time when the loss or outgoing was incurred, in respect of that benefit if the loss or outgoing had not been incurred by reason of, as a result of or as part of a tax avoidance agreement”. The benefit in the South Australian Battery Makers circumstances would be the use of the premises. In any event, the circumstances of that case may not involve a “tax avoidance agreement”, and an outgoing to attract the operation of s. 82KJ must have been incurred by reason of, as a result of or as part of a “tax avoidance agreement”. “Tax avoidance agreement” is defined in s. 82KH.

10.336 Where a payment is made in the circumstances of South Australian Battery Makers, but with the difference that the payment is greater than the amount that might reasonably be expected to have been incurred, s. 82KJ will operate to deny any deduction for the payment if it was incurred as a result of or as part of a tax avoidance agreement. It will be recalled ([9.19]–[9.20] above) that in South Australian Battery Makers Gibbs A.C.J. took the view that, despite Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2) (1976) 76 A.T.C. 6001, a denial of a deduction of part of the payment for rent would have been appropriate if the resulting benefit of a lowering of the price payable under an option to acquire the premises had accrued to the taxpayer by way of increase in the value of an interest in the associated company that held the option. In fact there was no accrual of benefit in this way, because the taxpayer did not hold shares directly or through another company in the company holding the option. The companies might be described as sister companies. Section 82KJ will be attracted where an associate “has acquired, will acquire or may reasonably be expected to acquire property by reason of, or as part of the tax avoidance agreement”. A company will be an associate, as that word is defined in s. 82KH(1) (b), in the circumstances of South Australian Battery Makers.

10.337 The wide definition of “associate” avoids some of the limitations, considered in [10.310]–[10.327] above, on the operation of s. 65(1). Thus a trustee of a trust estate or a company may be an associate of an individual taxpayer (s. 82KH(1) (a) (iv) and (v)). A trustee of a trust estate or a company may be an associate of a company taxpayer. A company may be an associate of a trustee of a trust estate.

10.338 It seems, however, that a trustee of a trust estate cannot be an associate of the trustee of another trust estate, nor can a partnership be an associate of a taxpayer.

10.339 The interpretation of the words “property has been, will be, or may
reasonably be expected to be, acquired by the taxpayer, or by an associate of the taxpayer” in s. 82KJ (c), raises important issues as to the operation of the section and its relationship to s. 65. A payment may be made to an associate which is not reasonable, having regard to all benefits in respect of which the payment was incurred. The payment may have been made in a simple plan of income shifting. It would not appear appropriate to describe the amount of the payment beyond a reasonable payment as property acquired by the associated person. The language of para. (b) and para. (d) contemplates that there is some property acquired by an associated person which is distinct from the receipt of the payment whose deductibility is in question. One would have expected any change in the law in regard to simple over-payments in income shifting to have been done through s. 65 (1). If s. 82KJ has no application, the deficiencies in the definition of “associated person” for purposes of s. 65 become important.

10.340 The interpretation of s. 82KJ (c) raises other issues. The person to whom payment is made by a taxpayer may not be an “associate” so that the issue discussed in the preceding paragraph cannot arise. The payment may be made to a trust or to a partnership. The question that may then arise for decision is whether the entitlement of a beneficiary or a partner to a distribution, or an actual distribution to a beneficiary or a partner, who is an associate of the taxpayer, can be described as property that will be or has been acquired by the associate. In this connection the interpretation of para. (c) will be affected by the provisions of para. (d). An acquisition of property will not engage the operation of s. 82KJ unless the consideration (if any) that was payable or might reasonably be expected to be payable in respect of the acquisition of that property was less than the consideration that might reasonably be expected to have been payable, or to be payable, if the outgoing had not been incurred. Paragraph (d) would appear to contemplate an acquisition that might have been the subject of some “consideration payable”. It would be straining the words of the paragraph to say that consideration was paid by the beneficiary or partner in the form of the rights to distribution that were satisfied by the distribution. In any event that consideration is not easily described as a consideration that is less than the consideration that might reasonably be expected to have been payable if the outgoing had not been incurred. If paragraph (c) does not apply to a distribution to a beneficiary or to a partner, s. 82KJ will not be applicable to the circumstances of an overpayment to a trust or partnership in the course of income-shifting. It will not apply to an overpayment in circumstances otherwise within Phillips (1978) 78 A.T.C. 4361.

10.341 Section 82KL was enacted shortly after s. 82KJ. It is limited in its operation to “eligible relevant expenditure” as defined in s. 82KH. The
The scope of “relevant expenditure”, also defined in s. 82KH, has been expanded on several occasions since the enactment of the section, so that the section now applies to a wide range of payments. Relevant expenditure is eligible relevant expenditure if the expenditure was incurred by reason of, as a result of or as part of a tax avoidance agreement, and the taxpayer or an associate has obtained a benefit or benefits in addition to the benefit in respect of which the relevant expenditure was incurred. The benefit in respect of which the relevant expenditure was incurred is specified for the items of relevant expenditure to which s. 82KL applies by definition in s. 82KH(1G). Any other benefit is an additional benefit. The definition refers only to the obtaining of an additional benefit by the taxpayer, but s. 82KH (1P) deems a benefit obtained by an “associate”, as defined in s. 82KH, to be a benefit obtained by the taxpayer. The notion of obtaining an additional benefit is intended to be broader than the notion of acquiring property in s. 82KJ, but s. 82KL may, none the less, not be wide enough to cover the overpayment situations considered in [10.339]–[10.340] above in relation to s. 82KJ. It is arguable that the additional benefit must be of a kind that could have been “obtained” by the taxpayer.

Section 82KL provides that where the sum of the amount or value of the additional benefit and the “expected tax saving” is equal to or greater than the amount of the eligible relevant expenditure, no deduction is allowable in respect of any part of the eligible relevant expenditure. “Expected tax saving” has a meaning given by a definition in s. 82KH(1), which is itself the subject of a definition in s. 82KH(1B). Normally, it is the amount by which the tax payable by the taxpayer would be less if a deduction were allowable in respect of the eligible relevant expenditure. The arithmetic of s. 82KL will limit the operation of the section to circumstances where the planning for a tax advantage has been immodest. In this respect it is narrower in its operation than s. 82KJ. If a company subject to tax on its taxable income at 46 per cent, or its associate, obtains an additional benefit that has a value that is less than 54 per cent of the amount of the relevant expenditure, s. 82KL will not operate. In other respects, s. 82KL has a wider operation. It does not require that the payment should be unreasonable in amount having regard to the benefit in respect of which the relevant expenditure was incurred. And it will operate if an additional benefit is obtained even though there could not be said to be an acquisition of property as s. 82KJ requires. It will operate, for example, where a consequence of the incurring of the relevant expenditure is the so-called collapse of a loan made to the taxpayer or an associate. It may have been agreed between the person receiving the payment and an associate of the taxpayer who has borrowed from that person, that the loan
should, on the making of the payment, become repayable at a date so delayed that the loan becomes virtually valueless. In circumstances of this kind s. 82KL is given an extended operation by s. 82KH(1J).

10.343 Section 82KH(1H) adapts s. 82KL so that it will apply in some circumstances involving the payment of interest in advance, like those in Ilbery (1981) 81 A.T.C. 4661 considered in [6.117]ff. above. The decision in Ilbery was that the interest paid in advance was not deductible under s. 51(1), so that, if the events were to occur now, there would be no room for the operation of s. 82KL. But s. 82KL may indicate the difficulty of dealing with tax planning that relies on an anticipated judicial decision that an outgoing is deductible under s. 51(1). The operation of s. 82KL in the circumstances of Ilbery is extended by s. 82KH(1H). The family trust that acquired the debt is deemed to have obtained a benefit being the difference between what was paid for it and the amount of the debt, not, it should be noted, the value of the debt. In fact the debt had no greater value at the time it was acquired than the amount paid for it. The need to deem facts which are a drastic contradiction of the truth in order to bring about a denial of the deduction of the interest paid, underlines that any judicial decision upholding the deduction of the interest paid in Ilbery would have confounded basic principle. The integrity of the income tax once destroyed by a wrong decision on basic principle, cannot be fully restored by any legislation.

Division 3A of Part III (sections 82L-82T): convertible notes

10.344 In [6.301]–[6.307] above, there is a discussion of the distinction between an expense of deriving income and an application of income derived. In [6.304] above there is a reference to the significance of that distinction in relation to a payment of interest on debentures as distinct from a payment of a dividend on shares. Interest on debentures is, generally, deductible; dividends are not.

10.345 There will be circumstances, however, where interest on debentures becomes indistinguishable in its function from a distribution of profits as dividends. Thus, the debentures may be convertible into shares. There may be good reason for allowing the deduction of a distribution of profits by a company in the form of dividends, as a method of ensuring that profits moving through a company intermediary to a shareholder are not taxed at both the company and the shareholder levels. But while the separate taxation of profits derived by a company and dividends received by a shareholder is maintained, some restraint must be imposed on the deductibility of interest paid to holders of convertible debentures.
10.346 It might have been possible to deny deduction of interest on convertible debentures on the ground that such interest is not incurred in the process of income derivation. Since 1960, however, express provision has been made in what is now Div. 3A of Pt III denying deduction of interest on convertible debentures in specified circumstances. The 1960 provisions denied deduction on a broad front. In 1970 deductibility of interest on some convertible debentures was restored, and in 1976 further relaxation of the denial of deductibility was made. The restoration of deductibility is intended to provide scope for the use of convertible debenture as a means of raising capital. Deduction is allowed only if the convertible debentures meet strictly defined tests. Thus the option to convert must rest with the debenture holder so that, pending conversion, he has the income yield and security of investment that the loan provides.

10.347 If deduction were allowed of interest paid on all convertible debentures, the operation of the present separate system of taxing company profits would be undermined. That system, where no undistributed profits tax applies, depends for its operation on pressure by those who have an interest in accumulated profits for some measure of current distribution. In the case of a high-income shareholder, the under-taxation of undistributed profits is compensated for by the over-taxation, at company and shareholder levels, of distributed profits. In the case of a holder of convertible debentures, whose debentures give him a potential claim on a portion of undistributed profits, the pressure for current distribution is satisfied by the interest he receives.

Sections 108 and 109: payments to shareholders

10.348 Sections 108 and 109 provide for the denial of deduction by a private company (as defined in s. 103A) of certain payments made to shareholders and directors, and to relatives of shareholders and directors. These provisions have a purpose similar to the purpose of the provisions just considered denying deductibility of interest on convertible debentures. Payments that are in substance distributions of profits should be treated in that way.

10.349 In the case of payments covered by s. 108, deduction under s. 51(1) would in most instances have been denied in any case. The section is intended, however, to have the further function of ensuring that the receipt of the payment by the shareholder is income. In this respect the section may be ineffective. Where the section operates, the amount paid or asset distributed is deemed to be a dividend paid by the company. Rutherford (1976) 76 A.T.C. 4304 is authority that this is not enough to engage the
operation of s. 44(1) and make the receipt by the shareholder income. Section 44(1) makes a dividend out of profits income, and a deemed dividend under s. 108 will not be income if in fact it was not paid out of profits. The Commissioner's opinion that the payment represents a distribution of income, necessary if the payment is to be deemed a dividend, will not supply the element of fact that it is paid out of profits. And the deeming that the payment is a dividend does not in itself make it income. Gibb (1966) 118 C.L.R. 628 considered in [2.244] above, in overruling Fuller (1959) 101 C.L.R. 403, and adopting the dissenting judgment of Dixon C.J. in Fuller, is authority that the payment is only given the character of a payment within the definition of dividend in s. 6. And such a payment does not necessarily have an income character.

10.350 The scope of s. 108 is narrow in a number of respects. It is arguable that the section has no application to a payment made to a shareholder that is not made by way of advance or loan. The payment, if it is not made by way of advance or loan, must be one made “on behalf of, or for the individual benefit of” a shareholder. The section may not therefore apply to an over-payment made to a shareholder for goods or services provided by the shareholder.

10.351 The payment must have been made to, on behalf of, or for the individual benefit of a shareholder. “Shareholder” refers to a person registered as such, or having a right to be registered (Patcorp Investments Ltd (1977) 140 C.L.R. 247). The section has no application to a payment to a relative or other associate of a shareholder.

10.352 Crowe (1958) 100 C.L.R. 532 considered in [10.324] above may require a conclusion that a payment by a partnership is not a payment by a company that is a member of the partnership. Section 65(1) may fill this gap in the operation of s. 108—“associated person”, it will be recalled, is given an extended meaning by s. 65(1D) (b)—though the question for the Commissioner under s. 65(1) is whether in his opinion the payment is reasonable, while under s. 108 the question is, whether in the Commissioner's opinion the payment represents a distribution of income.

10.353 Like s. 65(1), s. 108 may not apply to a payment to a partnership, a partner in which is a shareholder in the company making the payment.

10.354 Section 109 shares some of the narrowness of s. 108, where, for example, a payment is made by a partnership or is made to a partnership. The deeming that the amount is a dividend will not be sufficient to make it income: it must have been in fact paid out of profits. And s. 109 has its own limitations. Thus it applies only to a “sum paid or credited”. This may not include the transfer of property other than money. Section 108 does extend in terms to “assets distributed”, though curiously only when this is
done “by way of advances or loans”, and in other circumstances, the application of the section is confined to “payments”.

10.355 Under s. 109 the Commissioner may deem a payment to a person who is not in fact a shareholder to be a dividend. The payment may have been made to a director or to a relative of a shareholder or director. It may be deemed to be a dividend if it is a payment that is or purports to be remuneration for services rendered by the person to whom the payment is made, or is an allowance gratuity or compensation in consequence of the retirement of that person from an office or employment held by him in the company, or upon the termination of any such office or employment. The deeming will arise if the Commissioner forms the opinion that the payment exceeds an amount that is reasonable. It will arise in relation to the excess.

10.356 Section 109 expressly provides that the excess is not an allowable deduction. There are dicta in *W. J. & F. Barnes Pty Ltd* (1957) 96 C.L.R. 294 that s. 109 can apply only when the payment would otherwise have been an allowable deduction, whether under s. 51 or possibly s. 78(1)(c) considered in [10.105]–[10.112] above. The interpretation of the section in this respect will be important where a retiring allowance of an unreasonable amount has been paid. The amount by which the payment exceeds a reasonable amount could be denied deduction under s. 51 as a payment made for a purpose that will not make it relevant to the gaining of assessable income. Issues already considered as to the effect of *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430 and *Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2)* (1976) 76 A.T.C. 6001 are raised. The excess is unlikely to be deductible under s. 78(1)(c). The Commissioner could not be expected to form the opinion that the excess was “paid in good faith in consideration of the past services” of the employee.

10.357 If s. 109 does not operate, because the payment would not otherwise be an allowable deduction, the payment may have the character of an eligible termination payment in the hands of the person receiving it so that it is subject to the operation of Subdiv. AA of Div. 2 of Pt III: para. (a)(v) of the definition of eligible termination payment in s. 27A(1) will not operate to take the amount out of the definition.

10.358 Where s. 109 operates, it will deem the excess to be a dividend paid by the company. If *Rutherford* (1976) 76 A.T.C. 4304 is followed, it will not necessarily be income of the person receiving the payment. It must in fact have been paid out of profits. And there is another-problem. The person receiving what is deemed to be a dividend may not be a shareholder in the company, and unless he is deemed to be a shareholder there could be no derivation of income by him under s. 44(1). The question is whether a deeming of a payment to be a dividend is a deeming that the person
receiving the amount is a shareholder. The definition of “dividend” in s. 6 refers in all its aspects to payments to shareholders.

Division 13 (sections 136AA-136AG)—international agreements

10.359 Section 31C, considered in [10.290]–[10.293] above, was inserted in the Act following the decision in Isherwood & Dreyfus Pty Ltd (1979) 79 A.T.C. 4031. Though not confined in its operation to income shifting in international transactions, s. 31C empowers the Commissioner to deny a deduction of some part of the amount paid for trading stock in the circumstances of Isherwood & Dreyfus, which involved an international transaction.

10.360 A new Div. 13 was inserted in the Act in 1982, applicable where there is an international agreement as defined in s. 136AC. In the application of Div. 13, the operation of s. 31C must be disregarded (s. 136AB(2)). The effect is presumably, that the Commissioner may act under s. 31C, if he has not determined that s. 136AD(3) should apply. The definition of “international agreement” in s. 136AC is intended to identify situations where the parties to a transaction may have fixed the price of property or services so as to shift income from a person who would have been subject to Australian tax on that income, to another person not subject to Australian tax, or to another person who will be subject to Australian tax at a lesser rate, for example tax by withholding at 10 per cent on interest received by him. The shifting of income might take the form of charging a lower price for property or services supplied to a person who will not be subject to Australian tax on the profit he may make in supplying those goods or services to another. Or it might take the form of charging a higher price for property or services supplied to a person who will be subject to Australian tax on the profit he makes, a profit that will be the less because of the higher price he has paid. The present concern is with the operation of Div. 13 where the form of income shifting is the charging of a higher price. The general effect of Div. 13 in these circumstances is to limit the deduction that is allowable, or the cost that will determine the amount of a profit that is income, to the amount that would have been paid for the property or services had the parties been dealing at arm's length with each other.

10.361 Section 136AD(3) applies only when “property” has been acquired under an “international agreement”. The latter term is defined in s. 136AC. “Property” is defined in s. 136AA(1), so that it includes “services” and services is defined so that it includes rights provided under an agreement for or in relation to the lending of money. Where the Commissioner is
satisfied that the parties to the agreement, or any two or more of those parties, were not dealing at arm's length with each other in relation to the acquisition of property, and the amount of the consideration in respect of the acquisition exceeded the arm's length consideration in respect of that acquisition, the Commissioner may determine that s. 136AD(3) should apply. In which event, consideration equal to the arm's length consideration will be deemed to be the consideration given by the taxpayer. “Arm's length consideration” is defined in s. 136AA(3) (d). It is the consideration that might reasonably be expected to have been given, or agreed to be given, if the property had been acquired under an agreement between independent parties dealing at arm's length with each other in relation to the acquisition. The arm's length consideration is a matter of fact. There is however a function given to the Commissioner by s. 136AD(4), if for any reason it is not possible or not practicable to ascertain the arm's length consideration, to determine an amount which is then deemed to be the arm's length consideration. It will have been noted that under s. 31C the “arm's length price” is a matter in all circumstances of the Commissioner's opinion.

10.362 Like s. 31C, Div. 13 provides for carrying the arm's length price determined in relation to one party, into the tax affairs of another party to the international agreement. However, Div. 13 differs from s. 31C in that consequential adjustments to the assessable income of the other party depend on the exercise of a distinct discretion given to the Commissioner by s. 136AF. Under s. 31C the consequential adjustment is automatic: the price determined in accordance with the section is deemed to be the amount paid “for all purposes of the application of the Act in relation to the purchaser and the vendor” (s. 31C(1)).

Part IVA: schemes to reduce income tax

10.363 Part IVA is the subject of further consideration in Chapter 16 of this Volume. The present purpose is to note the possible operation of Pt IVA so as to deny deduction of an outgoing otherwise allowable. Part IVA applies to any scheme where a taxpayer has obtained a tax benefit in connection with the scheme and, having regard to a number of specified circumstances, it would be concluded that the persons or one of the persons who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the taxpayer, or that taxpayer and another or other taxpayers, to obtain a tax benefit in connection with the scheme. “Scheme” is defined in s. 177A(1), so that it is a very wide concept. Tax benefit is defined in s. 177C so that it includes a deduction being allowable
to a taxpayer where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, if the scheme had not been entered into. The word “scheme” might be thought to carry some suggestion of an evil mind, but any such suggestion is removed by the definition of the word. Part IVA thus may operate to deny a deduction simply because a taxpayer acted for the purpose of obtaining the tax deduction. At least where it is evident that the policy of the Act is to allow a deduction as a means of attracting the taxpayer into a course of action that is thought to be desirable—the investment allowance may be an illustration—a provision that a taxpayer may not have a deduction because he acted to obtain it becomes bizarre in its inappropriateness. Section 177C(2)(b) goes some way to mitigating this quality of the bizarre, by making exceptions to the operation of Pt IVA where “the allowance of the deduction to the taxpayer is attributable to the making of a declaration, election or selection, the giving of a notice or the exercise of an option by any person, being a declaration, election, selection notice or option expressly provided for by [the] Act”. But a measure of the bizarre remains. The “choice” principle in relation to s. 260, the predecessor of Pt IVA, sought to remove the suggestion of the bizarre, in the operation of that section, but the development of the “choice” principle in Mullens (1976) 135 C.L.R. 290 and Cridland (1977) 140 C.L.R. 330 left s. 260 virtually without any operation, save where the words of the Act have failed to express what is otherwise an evident policy opposed to the tax benefit.

10.364 A number of other questions as to the operation of Pt IVA are considered in Chapter 16 below. One of them is provoked by the discussion of the operations of s. 65 and ss 82KJ and 82KL in [10.310]ff. and [10.330]ff. above. It may be asked whether there can be a tax benefit, as defined in s. 177C, where a payment is made by a trust estate or by a partnership. Section 177C (1)(b) refers to a “deduction being allowable to the taxpayer”. It is true that a calculation of “net income” of a trust estate required by s. 95(1) involves bringing in what would be assessable income if the trustee were a taxpayer, and subtracting what would be allowable deductions if the trustee were a taxpayer. But this does not make an expense incurred by the trustee a deduction allowable to a taxpayer. A like observation might be made in regard to the calculation required by s. 90(1) of the net income in the case of a partnership. In the case of a trust estate, the definition of “taxpayer” in s. 177A(1) may overcome the difficulty—“taxpayer includes a taxpayer in the capacity of a trustee”. But there is no equivalent provision when the question is raised in regard to a partnership.

10.365 Part IVA, like s. 31C, s. 65 and Div. 13 of Pt III, includes a
provision, in s. 177F(3), whereby the Commissioner's denial of a deduction may lead to a reduction of the amount that is assessable income of another taxpayer. The making of the reduction by the Commissioner is a matter in his discretion, conditional upon the earlier exercise of his discretion to deny the deduction, but otherwise independent of the discretion to deny the deduction. In this respect Pt IVA is from the same mould as Div. 13 of Pt III, and differs from s. 31C and s. 65.

Provisions Allowing Deductions of Notional Expenses

10.366 In a number of provisions the Act allows deduction of what might be called notional expenses. The deduction, in a number of instances, is intended to overcome the distortions that may arise from the system of annual accounting applicable in determining the amount on which tax is levied. The deduction for losses carried forward from earlier years is the principal illustration. In other provisions a deduction may be allowed that is calculated by reference to an expense that is already deductible, though possibly over the life of some asset. The deduction is in addition to the deduction of the actual expense. The principal illustration is the investment allowance. A deduction may be allowed of a deemed expense where a transfer of income is for tax purposes to be treated as if the transfer had not been made. There is a deemed payment by the transferor to the transferee of the amount of income transferred, the deemed payment being for the purpose for which the income was transferred.

Sections 80-80F: losses of previous years

10.367 “Loss” as used in the provisions now to be considered has a meaning distinct from two other meanings already noted. The word as used in s. 51(1) refers to the failure of an asset to realise its cost. Section 59, in stating the events which may give rise to an item of assessable income or allowable deduction where property subject to depreciation ceases to be available to a taxpayer, uses the word loss in the sense of permanent deprivation of an asset. Loss in the present context refers to what might be called negative income of a year of income. It is defined in s. 80(1) as the excess, in any year of income, of allowable deductions over assessable income and net exempt income of that year. The meaning has its affinity with the meaning of the word in s. 51(1). The purpose of the provisions of ss 80ff., in allowing the deduction of the excess against income derived in later years, is to mitigate the distortion in the amount of income subject to tax that would arise if each year of income were treated as quite distinct
from each other year. The mitigation is however limited. The carry-forward of a loss to later years is limited to seven years, save where the loss is a loss incurred in engaging in primary production as defined in s. 80AA(2), in which event carry forward is unlimited in time. However no carry back of a loss is allowed to any taxpayer: a loss in one year cannot be applied against income derived in an earlier year. There are restrictions on the carry forward of a loss where the taxpayer becomes bankrupt. There are restrictions on the carry forward of losses applicable to all losses incurred by companies. A company will be denied the application of a loss carried forward if there has been a substantial change in the beneficial ownership of shares in the company or in certain other circumstances, unless the company carries on the same business. The policy of the restrictions on the carry forward of losses by companies is also reflected in the provisions of Subdiv. B of Div. 2A of Pt III considered in [10.294]-[10.300] above, the “current year loss provisions”. Those provisions were included under a heading concerned with the denial of deductions otherwise allowable. That is their effect. The provisions now considered allow a deduction for what is not in any sense an expense of the year of income, and may be seen as a notional expense. They then restrict the deduction of that expense where the taxpayer is a company.

The carry forward of losses not incurred in primary production or in the producing of a film

10.368 Section 80(1) provides that a loss shall be deemed to be incurred in any year when the allowable deductions (other than the concessional deductions and the deductions allowable under s. 80 or s. 80AAA or s. 80AA) from the assessable income of that year exceed the sum of that income and the net exempt income of that year, and the amount of the loss shall be deemed to be the amount of such excess. The reference to s. 80AA is to a provision governing the carry forward of a loss incurred by a taxpayer engaged in primary production. “Net exempt income” is defined in s. 80(3). The most significant item of exempt income is likely to be income that is exempt under s. 23(q)—foreign source income of a resident that is taxed in the country of source. “Concessional deductions” is defined in s. 6 to mean deductions allowable under Subdiv. C (interest in respect of housing loans) or E (expenditure in respect of home insulation) of Div. 3 of Pt III.

10.369 One aspect of the definition of a loss available for carry forward is that a loss when carried forward cannot create or increase a loss available for a new carry forward: If it could, the limitation on the period of carry
forward would be nullified. Section 80(2) provides for the application of a loss carried forward. It is first applied against net exempt income of a year of income and then against assessable income. Where there is more than one loss available for application, the losses are taken into account in the order in which they were incurred.

10.370 There are problems of correlating the provisions as to the determination of a loss available for carry forward and as to the application of such a loss. The most effective correlation will be achieved if it is accepted that there is assessable income and net exempt income in a year of income to receive the application of a loss to the extent that the operation of s. 80(1) fails to give rise to a loss available for carry forward in the year of income. Where the allowable deductions that are subtractable under s. 80(1) are less than assessable income, there will be assessable income to receive the application of a loss carried forward. Where those allowable deductions exceed the assessable income and there is net exempt income, there will be net exempt income to receive the application of the loss carried forward to the extent that the allowable deductions are less than the assessable income and the net exempt income.

Losses incurred in primary production or in the producing of a film

10.371 Specific provisions relating to particular industries are not examined in any detail in this Volume. Sections 80AA and 80AAA provide for the determination of the amount of a “loss incurred in engaging in primary production” and the amount of a “film loss”, and for the application of these losses. In the case of a film loss, there are restrictions on the application of the loss that do not have any parallel in the primary production loss provisions. And unlimited carry forward is available only in respect of a loss incurred in primary production.

The consequences of bankruptcy

10.372 A loss cannot be carried forward through the bankruptcy of the taxpayer. Section 80(4) denies the deduction of a loss carried forward if a taxpayer has become a bankrupt, or has been released from any debts by the operation of an Act relating to bankruptcy. The denial is to a degree qualified by subss (4A) and (4B) of s. 80, so that a deduction is allowable of an amount paid in respect of a debt that the Commissioner is satisfied was taken into account in ascertaining the amount of the loss. The policy of the qualification is not apparent. An appropriate qualification might have allowed the loss carry forward to the extent that it arose from debts contracted and paid, whether paid before or after bankruptcy and whether
paid by the trustee or by the bankrupt.

10.373 There are provisions in s. 80AA (subss (6), (7) and (8)) relating to primary production losses, and in s. 80AAA (subss (9), (10) and (11)) in regard to film losses, which parallel the provisions of s. 80 as to the effect of bankruptcy.

Losses resulting from schemes of tax avoidance

10.374 A number of provisions of the Assessment Act have been enacted in more recent years directed against what have come to be referred to as schemes of tax avoidance. Among these are s. 52A (considered in [10.306]-[10.309] above), ss 82KH-82KL (considered in [10.328]ff. above) and Pt IVA (considered in [10.363]ff. above). All of these anti-avoidance provisions commenced their operations from specified dates. However a number of provisions of s. 80 (subss (5), (6) and (7)) and of s. 80AA (subs. (12)), give these anti-avoidance provisions, so far as they could be applicable, a limited earlier operation. In effect the anti-avoidance provisions are deemed to be in operation at an earlier date for the purpose of determining whether there are losses available for carry forward.

Restrictions on loss carry forward by companies

10.375 Provisions for loss carry forward may be seen as some expression of a policy that Government should contribute towards a loss suffered by a taxpayer who in other years contributes part of his profit to Government in the form of tax paid. In the case of an individual, the policy allows a Government contribution only to the extent of what would otherwise be the taxpayer's liability to contribute in other years, and then only when the liability to contribute arises in years subsequent to the year of loss. There is no question of contribution by Government by way of negative tax in the year of loss, and there is no carry back of losses. The Government contribution by relief from tax in the year of carry forward is available only to the taxpayer who suffered the loss. He cannot dispose of the inchoate right to a contribution by Government, nor will it be available to his estate or to his heir if he dies.

10.376 At first sight these principles are maintained where the taxpayer is a company. Save where s. 80G operates so as to allow the transfer of a loss within a group of companies, the company cannot dispose of its inchoate right, and loss carry forward ceases to be available if the company is liquidated. There will however, in the absence of special provisions applying to companies, be an opportunity for the shareholders in a company to realise the inchoate right to a Government contribution by
selling their shares. And the inchoate right will not be affected by the death of a shareholder. The value of shares attributable to the inchoate right will survive the death of the shareholder.

10.377 In fact, special restrictions have been applied to the carry forward of losses by companies, intended to overcome the advantage over operating as an individual that would otherwise be attracted to operating through corporate form. The restrictions are a compromise that allows for some preservation of the inchoate right despite a disposition of shares by a shareholder or a change in ownership resulting from the death of a shareholder. Loss carry forward by the company can be retained if there is a continuity of beneficial ownership of shares covering more than 50 per cent of the shares, and continuity of ownership is not affected by the death of a shareholder so long as the shares are held by the trustee of the shareholder's estate in his capacity as trustee, or are beneficially owned by a person who received the shares as beneficiary in that estate.

10.378 The provisions deeming a continuity of beneficial shareholding in the event of a death of a shareholder are in s. 80B(3). There is a question of the meaning of the words which refer to a person “who received the shares as a beneficiary in [the] estate”. It is arguable that a beneficiary who takes shares in specie in satisfaction of his interest in an estate, when the shares would otherwise have to be sold and the proceeds distributed, does not receive the shares as a beneficiary.

10.379 The provisions denying loss carry forward where there is an insufficient continuity of beneficial ownership are contained in ss 80A-80E. The significance of the related provision in s. 80F has already been explained in [10.78]-[10.82] above.

10.380 Section 80A(1) denies the deduction of a loss by a company unless there is a continuity of beneficial ownership of shares exceeding one half, at all times in the year in which the loss was incurred and in the year in which it is sought to apply the loss. Section 80A (1) is subject to ss 80B, 80DA and 80E. The operation of s. 80B may deem shares not to be beneficially owned in some circumstances. And s. 80DA may, in the circumstances provided in the section, deny the carry forward notwithstanding that a continuity of beneficial ownership exceeding one half can be established. Section 80E however works a qualification on ss 80A (1) and 80B, and, it seems, on s. 80DA, so that loss carry forward will be available despite those provisions if the same business is carried on by the taxpayer in the year of loss and in the year of claimed application of the loss.

10.381 Section 80A (1) defines the continuity of beneficial ownership that is prima facie necessary if loss carry forward is to be allowed. There must
be continuity of beneficial ownership of shares carrying between them more than one half the voting power, the right to receive more than one half of any dividends that may be paid by the company and the right to receive more than one half of any distribution of capital of the company. The beneficial ownership must subsist at all times in the year of loss and in the year of claimed application of the loss, subject, however, to a discretion given to the Commissioner by s. 80A (5), where a change occurs in beneficial ownership during a year of loss, to allow the application of such part of the loss as he considers to be the amount of the loss that was incurred after the change in beneficial ownership.

10.382 The continuity of beneficial ownership required by s. 80A (1) must be established to the satisfaction of the Commissioner, where the company is a private company as defined in s. 103A. Where it is not, loss carry forward will be denied unless “the Commissioner considers that it is reasonable to assume” that the tests of continuity of beneficial ownership in s. 80A (1) are met. The tests all refer to a “right” to exercise power, or to receive dividends and distributions of capital. The tests are cumulative. It may be asked whether the Commissioner could ever be satisfied, or consider it reasonable to assume, that the tests are met, where the articles of the company include a differential dividend clause which gives the board a discretion to pay a dividend on some shares to the exclusion of other shares, or include a clause allowing differential distribution of capital. In these circumstances no share would appear to give a “right” to a dividend that “may be paid”, or the right to receive a distribution of capital.

10.383 Where shares in the company are held by a trust, it is the “beneficial” ownership of the shares that is relevant. Where shares in the company are beneficially owned by another company, or another company has an interest in its shares, the operation of s. 80A (1) may be displaced by subss (2) and (3). It will be displaced if the company requests the Commissioner that sub. (3) should apply, or the Commissioner considers it reasonable that sub. (3) should apply. Where sub. (3) applies, loss carry forward will be denied unless the Commissioner is satisfied or considers that it is reasonable to assume that, through interposed companies trusts or partnerships, persons not being companies had continuing beneficial interests in the nature of control of voting power, rights to receive dividends and rights to receive distributions of capital, parallel with the rights that must be carried by shares under s. 80A (1) if continuity of beneficial ownership is to be established under that subsection. The manner in which interests in dividends and distributions of capital are to be established is the subject of sub. (4). As in the case of s. 80A (1), there is a problem as to the operation of subss (3) and (4) where the board of a
company is given a discretion as to the payment of dividends or distribution of capital.

**10.384** The applicability of subss (3) and (4) on request by the company, will be important to the company where there has been a change in the share-holding in the company that would require that the loss carry forward should be denied under s. 80A (1), but the change in ultimate interests of persons who are not companies is not enough to defeat loss carry forward under s. 80A (3). Shares in a company that has suffered losses may have been disposed of by its holding company to a sister company. The company disposing and the company acquiring may be wholly owned subsidiaries of another holding company.

**10.385** The applicability of subss (3) and (4) where the Commissioner considers it reasonable that subs. (3) should apply, will be important to the Commissioner where there has been no change in shareholding in the company that has suffered losses, but there has been a change in the interests of persons in a company that holds shares in the company that has suffered losses.

**10.386** Section 80B (5) empowers the Commissioner in some circumstances to treat shares as not being beneficially owned in the year of income of claimed application of a loss. The circumstances set out in the subsection in para. (b), contemplate an agreement entered into before or during the year of income, or the giving of a right, power or option which “in any way directly or indirectly, related to, affected, or depended for its operation on” any one of four specified matters. These matters concern:

(i) the beneficial interest of a person in shares where that interest is relied on by the company to satisfy the requirement of continuity of beneficial ownership, or the value of that interest;
(ii) the right of that person to sell, or otherwise dispose of, that interest or any such sale or other disposition;
(iii) any right carried by those shares, or the exercise of any such rights; and
(iv) any dividends that might be paid, or any distribution of capital that might be made, in respect of those shares, or the payment of any such dividends or the making of any such distribution of capital.

By para. (c) of the subsection, the Commissioner's power to treat the shares as not being beneficially owned is also dependent on the agreement having been entered into, or the right, power or option having been given or acquired, for the purpose, or for purposes that included the purpose, of enabling the company to take the loss into account. By subss (10) and (11) “agreement” is given a broad meaning, and any of the words “agreement, right, power or option” may be satisfied though there is no right of
enforcement by legal proceedings, and none was intended.  

10.387 Two decisions of the High Court on the interpretation of s. 80B (5), and observations made in those cases, justify a number of conclusions as to the effect of the subsection. Those cases are *K. Porter & Co. Ltd* (1977) 52 A.L.J.R. 41, and *Students World (Australia) Pty Ltd* (1978) 138 C.L.R. 251. An agreement by the continuing shareholders that they will not sell their shares may attract the operation of s. 80B (5). Clearly, subpara. (b) (ii) is satisfied, and the purpose of the agreement may be to enable the company to take the loss into account, so that para. (c) would be satisfied: the purpose was to ensure that something does not happen—the sale of their shares by the continuing shareholders—that would preclude the required continuity of beneficial ownership. There is no decision on the matter of whose purpose it is that matters, and whether the purpose that is relevant is an objective or subjective purpose. 

10.388 An option given by the continuing shareholders to a person who has acquired shares, the option enabling him to acquire the shares of the continuing shareholders after the loss has been applied by the company, may satisfy subpara. (b) (i) or (ii). In this instance the purpose of enabling the application of the loss may be found in the reassurance given to the person who has taken the option that he can shift income to the company without thereby conferring a continuing benefit on the continuing shareholders. Any increase in the value of their shares ensues through the option to the ultimate benefit of the person who has taken the option. 

10.389 An agreement that the continuing shareholders will exercise their powers so as to make the persons who have acquired shares directors of the company may satisfy subpara. (b) (i) and subpara. (b) (iii). In this instance the purpose of enabling the application of the loss may be found in the purpose to give the control of the management of the company to the persons who have acquired shares, so that profits might be made against which the loss will be applied. On the basis of a similar analysis, the giving of proxies by the continuing shareholders may satisfy subparas (b) (i) and (b) (iii), and para. (c). 

10.390 An agreement by which shareholders undertake to sell less than half of their shares to a buyer may attract the operation of s. 80B (5), if the agreement is left unexecuted. Until the agreement is executed it affects all their shares. When the agreement is executed, it does not affect the shares that remain in the hands of the continuing shareholders in a way that will attract the operation of s. 80B (5). 

10.391 Subsection (6) of s. 80B is directed against provisions in a company's memorandum or articles, or in an agreement, by which shares which have been retained by continuing shareholders will or may cease to
have rights at any time after the end of the year of claimed application of a loss. The shares are deemed not to have had those rights during the year of claimed application of the loss. Subsection (7) makes similar provision in regard to provisions by which shares in the company will or may commence at any time after the end of the year of claimed application of the loss to carry rights that they did not carry at any time during that year. Such shares would enable those who have acquired shares in a company that has suffered losses to come to have control of the company after the losses have been applied.

10.392 Section 80DA was added to the Assessment Act in 1973 at a time when the provisions of ss 80A and 80B were amended in ways that made the limitations on carry forward more stringent. Thus the continuity of interest required was increased from 40 per cent to more than 50 per cent. Section 80DA was intended to increase the limitations. The section has an operation distinct from the operation of ss 80, 80AA and 80AAA: it commences “Notwithstanding section 80, 80AAA and 80AA . . . ”.

10.393 Section 80DA (1) specifies in a number of paragraphs circumstances which will prevent the carry forward of a loss by a company. Each is specified in broad terms, though some qualifications may result from the interpretations of s. 80DA (1) that are contained in the remaining subsections of s. 80DA. Paragraph (a) of subs. (1) is directed to the shifting of income to a loss company in the year of loss—“during the year of income the company derived income that the company would not have derived if the loss, or part of the loss, had not been available to be taken into account”. Paragraph (a) of subs. (1), standing alone, would deny loss carry forward to a company that is one of a number of wholly owned subsidiaries, where income has been shifted, by transfer pricing, from another subsidiary. This is to assume that a company derives income that it would not have derived if the loss had not been available, if it sells goods that it would not otherwise have acquired, or would otherwise have acquired at a higher cost. However s. 80DA (2) qualifies the operation of para. (a) so that the paragraph is inapplicable “where the continuing shareholders will benefit from the derivation of the income to an extent that the Commissioner considers to be fair and reasonable having regard to their rights and interests in the company”. “Continuing shareholders” is defined in s. 80DA (6) so that the phrase refers to persons on whose holdings or interests the company might rely for purposes of showing the continuity of ownership or interests that will satisfy s. 80A (1) or s. 80A (3). In the situation of a transfer of profits between sister subsidiaries para. (a) of subs. (1) should not therefore preclude loss carry forward.

10.394 But para. (b) of subs. (1) raises a prospect of such a denial. Even
when read with subss (4) and (5), para. (b) leaves the prospect that the advantage a subsidiary derives in not having to pay tax on income shifted to its sister subsidiary—a company that has suffered losses—will preclude the carry forward of losses by the sister subsidiary. Subsection (4) prevents the operation of para. (b) of subs. (1) only where an advantage has been obtained by a person who had a shareholding interest in the company that claims the application of a loss. It is not clear why the operation of para. (b) should be precluded only in these circumstances. Indeed the purpose of para. (b) is less than clear.

10.395 Paragraph (c) of s. 80DA (1) will deny loss carry forward where there has been some action in the conduct of the business affairs of the company claiming the application of a loss, which discriminates against the continuing shareholders—persons on whose continuing shareholdings or continuing interests the company might rely as satisfying the tests imposed by subss (1) or (3) of s. 80A (s. 80DA (6)). The making of loans only to new shareholders may be an illustration. Paragraph (c) will also deny loss carry forward where there has been conduct of the “affairs” of the company “without proper regard to the rights, powers or interests of continuing shareholders in the company”. Conduct of affairs which fails to recognise the “rights [or] powers” of the continuing shareholders may not be difficult to identify. The failure to pay a preferential dividend to which the continuing shareholders are entitled may be an illustration. Another illustration may be the failure to give notices of meetings to continuing shareholders. Conduct of affairs which does not have proper regard for the interests of continuing shareholders may be more difficult to identify. Action which discriminates against continuing shareholders, for example in the making of a new share issue, would no doubt be within para. (c), though such action may in any event bring s. 80A (1) into operation so as to deny loss carry forward. Where action does not discriminate—it may be a failure to pay any dividend—the operation of para. (c) is not clear. It is perhaps arguable that proper regard is not given to the “interests” of continuing shareholders if moneys that would otherwise be available to pay a dividend are used to repay debts owed to the new shareholders. The debts may have been acquired by the new shareholders as part of the arrangement under which they acquired their shares.

10.396 Paragraph (d) would appear to make an assumption about the operation of s. 80A (1). The acquisition by a person of voting control of a company might be thought to involve necessarily a change in beneficial ownership that would involve a denial of loss carry forward under s. 80A (1). If, however, emphasis is placed on the words of s. 80A (1) that refer to “persons who . . . beneficially owned shares . . . carrying between them”
the rights specified, the acquisition of voting control by one person as a result of movements in shareholdings among persons all of whom were and remain shareholders, would not involve a denial of loss carry forward under s. 80A (1). Paragraph (d) would appear to assume that this is so, and it provides for the denial of loss carry forward if the acquisition of control in this way was undertaken in order that loss carry forward would continue to be available. But the operation of the paragraph is less than clear.

10.397 The denials of loss carry forward by ss 80A and 80DA are subject to the saving provisions of s. 80E. A continuity of business may preclude a denial of loss carry forward by the operation of s. 80A, or s. 80DA, at least where that section would operate in addition to s. 80A. There may be some question whether s. 80E will act to save the application of a loss carried forward where there is the necessary continuity of ownership for purposes of s. 80A, and s. 80DA would operate alone to deny carry forward.

10.398 Section 80E was added to the Assessment Act in 1964 at a time when ss 80A and 80B were enacted. Important changes were made to s. 80A and s. 80B in 1973, but any changes to s. 80E at that time were matters of drafting only. It was said at the time of enactment that s. 80E would be a saving provision of a kind that appeared in United States and United Kingdom law. The policy of the section is none the less a matter of speculation. It may be asked why a market in the shares of companies that have suffered losses should be encouraged where the buyers are prepared to maintain the businesses of the companies. The answer may be that a company's business, albeit an unsuccessful business, is a commercial entity whose preservation is important. The buyer may be able to revive and foster this entity, though it will be seen that the tests of continuity of business in s. 80E, that must be satisfied if loss carry forward is to be allowed, may hamper his actions directed to those ends.

10.399 Any analysis of the framework of s. 80E and the interpretation of its provisions pose difficult questions. Even more difficult is a threshold question as to the correlation of s. 80E and s. 80DA. Section 80DA was added to the Act in 1973 but no attempt has been made in any detail to adapt the language of s. 80E so that the section may clearly operate as a saving provision that will preclude the denial of loss carry forward by s. 80DA. Section 80E simply states that where its provisions are complied with “sections 80A and 80DA do not prevent the whole of the loss being . . . taken into account”. And s. 80DA(1) itself, in its opening words, provides for the denial of the application of a loss “subject to s. 80E”.

10.400 The operation of s. 80E(1) is however by its terms predicated on there otherwise being a denial of the application of a loss “by reason of a change that has taken place in the beneficial ownership of shares in the
company or in any other company” (s. 80E(1) (a)). Section 80DA does not deny the application of a loss by reason of such a change, though some change of that kind is likely to have been associated with the circumstances which give rise to a denial under s. 80DA. Section 80DA will no doubt have a saving operation where there will otherwise be both a denial under s. 80A by reason of a change, and a denial under s. 80DA by reason of circumstances specified in that section. It would be strange then that there should be no saving operation where only s. 80DA operates to deny. Yet it will demand a very free interpretation of s. 80E to give effect to the undoubted intention that continuity of business should prevent the denial of the application of a loss where only s. 80DA would operate to deny.

10.401 An analysis of the framework of s. 80E raises a question of the significance of the word “the” in the phrase “the same business” in para. (b) of s. 80E(1). On one analysis it is necessary to find one business covering all the business activities of the company immediately before the change, and to find that same business carried on in the year of application of the loss. There may be difficulty in finding, and, indeed, in describing, this one business where the company is a conglomerate engaged in a number of diverse activities in separate divisions, each one of which would ordinarily be regarded as a separate business. On another analysis, s. 80E (1) (b) would be read as if it had provided “carried on . . . [a] business the same . . . as it carried on immediately before the change”. This analysis is clearly the more convenient, and it will be seen, makes it easier to fix the operation of para. (c) of s. 80E(1). It is the analysis asserted by the taxpayer in Boyded (Holdings) Pty Ltd (1982) 82 A.T.C. 4236. A car selling activity in the outer suburbs, it was submitted, was a business distinct from another business constituted by wholesale car parts activity in inner suburbs. The fact that the car selling business had been sold before the year of claimed application of the loss did not prevent there being a continuing business of wholesale spare parts selling that was the same as a business carried on before the change in beneficial ownership of shares in the company. If the analysis that requires all business activity before a change to be regarded as one business is correct, the taxpayer in Boyded (Holdings) is faced with the task of establishing that the sale of the car selling division of one business did not prevent that business remaining the same business. In that task he may be defeated by the persuasive authority of the judgment of Walton J. in Rolls-Royce Motors Ltd v. Bamford (1976) 51 T.C. 319.

10.402 An analysis of the kind asserted in Boyded (Holdings) makes it easier to explain the operation of para. (c) of s. 80E(1). It will be noted that, in its reference to business, para. (c) contemplates that the taxpayer
may have a business in the year of application of the loss distinct from a business that it carried on “before”—presumably at any time before—“the change took place”. The saving effect of s. 80E is not destroyed by para. (c) if a business carried on after the change is a business “of a kind” that the company carried on before the change. So understood, para. (c) is inconsistent with the one business analysis of para. (b), and points to an analysis of that paragraph of the kind asserted in Boyded (Holdings).

10.403 There is thus the possibility that a new business may be commenced after the change which will not destroy the saving effect, provided it is a business of a kind that was carried on at some time before the change. Presumably if a business has ceased, a business of the same kind commenced thereafter cannot be the “same business” for purposes of para. (b), but it may be a business of the same “kind” for purposes of para. (c). There is also the possibility that if a new business commenced after the change is not of the same kind as a business carried on before the change so that the saving effect of s. 80E is precluded, the saving effect in a subsequent year of income may be restored by a cessation of that new business before that subsequent year of income.

10.404 The second limb of para. (c) will preclude the saving operation of s. 80E if at any time during the year of claimed application of the loss the company derived income from a transaction that it had not entered into in the course of its business operations before the change in beneficial shareholding. On the face of it this limb of para. (c) will preclude the operation of s. 80E even though the new transaction does not prevent a business after the change being the same business for purposes of para. (b), and does not prevent a business after the change being a business of a kind carried on before the change for purposes of the first limb of para. (c). A company may not previously have entered into credit arrangements in making sales. Granting of credit to customers in the year of claimed application of a loss may not have the consequence that a business has ceased to be the same business or ceased to be a business of a kind not carried on before the change. But if a credit transaction is a different kind of transaction from the cash transactions previously entered into, the second limb of para. (c) would appear to exclude the saving effect of s. 80E.

10.405 However, Sheppard J. in J. Hammond Investments Pty Ltd (1977) 77 A.T.C. 4311 has endeavoured to limit the operation of the second limb of para. (c) in excluding the saving effect. He said (at 4318):

“I have reached the conclusion that the second limb of the paragraph is not intended to refer to the daily transaction involved in carrying on a business but to transactions of an isolated and independent kind, which transactions have
nevertheless arisen in the course of the taxpayer's business operations.”

On this interpretation, regular credit transactions, though they are of a kind not previously entered into, will not preclude the saving effect of s. 80E. But an isolated lease transaction, producing rent, which occurs in the course of property dealing—property having been acquired that is tenanted—will preclude the saving effect, if no lease transaction has been entered into prior to the change. Regular transactions, though of a different kind will go only to the question whether there is a business that is the same as a business carried on before the change, or whether there is a business after the change of a new kind. Only an isolated transaction can involve the risk of precluding the saving effect of s. 80E by attracting the operation of the second limb of para. (c). The interpretation proposed by Sheppard J. will favour the company whose experience before the change has included the greatest diversity of income producing transactions. And it has the consequence that, though the saving effect of s. 80E may be precluded by a transaction in the year of income, the saving effect may be restored in a later year of income by ensuring that no isolated transaction is entered into. The interpretation of Sheppard J., it should be noted, is not endorsed by the judgment of Campbell J. in Fielder Downs (W.A.) Pty Ltd (1979) 79 A.T.C. 4019. The interpretation gives the second limb an operation that might be considered fortuitous.

10.406 Subsection (2) of s. 80E is directed against action that would involve commencement of a business, or entering into a transaction, before a change in beneficial shareholding occurs, for the purpose of ensuring that carrying on of that business after the change or deriving income from a transaction of that kind after the change, will not preclude the saving operation of s. 80E. The terms of s. 80E(2) assume the analysis of s. 80E(1) (b) asserted in Boyded (Holdings) Pty Ltd and thus lend support to the analysis. It is assumed that the carrying on, after the change, of a business that was commenced before the change will satisfy the test in para. (b) of s. 80E(1), even though the company had another business at the time of the change which may have ceased to be carried on.

10.407 Where the commencement of a business before the change or the entering into a transaction before the change was done for the purpose of attracting the saving operation of s. 80E, that saving operation is denied by s. 80E(2). The commencement of a business will result in the denial of the saving operation of s. 80E(2) only when it is a business that the company “had not previously carried on”. Presumably, in this context, the words “of a kind” must be read in. A business now commenced could not be the same business as one previously carried on. It follows that the commencement of a business prior to the change, even though for the purpose of attracting the saving operation of s. 80E, will not cause the loss of that saving operation if it is a business of a kind that the company had carried on at some time previously.

10.408 Judicial interpretation of s. 80E has been concentrated on para. (b), the question being whether business operations in the year of claimed
application of a loss are such that there is not the same business as that carried on immediately before the change. The assumption in the cases, save in *Boyded (Holdings) Pty Ltd* (1982) 82 A.T.C. 4236, has been that the company has not at any time carried on more than one business, and the possibility of differing analyses of para. (b) canvassed in paras [10.401]–[10.403] above has not been relevant. The question whether business operations in the year of claimed application of the loss involve the same business as a business carried on immediately before the change—the question posed by para. (b) of s. 80E(1)—is different from the question whether the business operations in the year of claimed application of the loss involve a business that is different in kind from a business carried on at any time before the change—the question posed by the first limb of para. (c) of s. 80E(1). The latter question is reserved for later comment.

10.409 The judgment of Gibbs J. in *Avondale Motors (Parts) Pty Ltd* (1971) 124 C.L.R. 97 offers “identical” as the meaning of “same” in s. 80E (1) (b), which excludes a meaning that would say that it is enough that the business in the year of claimed application of the loss is of the same kind as a business before the change. But “identical” is a word that itself calls for interpretation. The judgment of Gibbs J. in *Avondale Motors* justifies an inference that once a business ceases, a newly commenced business cannot be the same business as the business that ceased. The notion of cessation is indeterminate to a degree. *A.G.C. (Advances) Ltd* (1975) 132 C.L.R. 175 would draw a distinction between cessation and suspension, and suggests that business operations resumed after suspension may be the same business as the business that was suspended.

10.410 The Full High Court in *A.G.C. (Advances)* may have weakened the standing of *Avondale Motors*. *A.G.C. (Advances)* raised a question of contemporaneity and its significance in relation to deductibility under s. 51 (1). The case was considered in [10.27]ff. above. The relevance of the case to the interpretation of s. 80E is remote.

10.411 A change in the shareholding of a company will not affect the identity of the company's business. This is an assumption in the very terms of s. 80E. And, one would think, a change in management or in staff engaged in carrying on business operations should not affect identity. It is true that such changes were mentioned by Gibbs J. in *Avondale Motors* but the reason for any significance given to them is not explained.

10.412 A change in the name of the company may affect the identity of its business. *Avondale Motors* and *Fielder Downs* (1979) 79 A.T.C. 4019 suggest a principle which would assert that an event which brings about an immediate change in the goodwill within which the business operations of a company are conducted, will affect the identity of its business. It would
be said that a change in name, at least when it is a radical change, involves
the abandonment of personal goodwill associated with the former name.

10.413 A change in place of operations may affect identity. It may have the
effect of abandoning local goodwill. If the change in place of operations is
accompanied by a change in name, as was the case in *Avondale Motors*, it
will be very difficult thereafter to claim identity. In *Avondale Motors* there
was an added factor: the company ceased to operate under a franchise
given by one motor vehicle manufacturer and began to operate under
another. This factor, added to the factors of change of name and locality of
operations, made the change in the goodwill within which the company's
operations were conducted a complete change. The change of franchise in
*Avondale Motors* has its parallels in other changes which will involve the
loss of one group of customers and the acquiring of another. A taxpayer
who has exclusively offered agistment for cattle on his land, and now turns
to raising his own cattle on his land, has moved from one group of
customers to another. A change in operations that involves a movement
from one group of customers to another group may in some sense be a
natural progression—a company engaged in the production of clover seed
on its land may switch to the raising of cattle on that land. *Fielder Downs*
is authority that identity of business is none the less affected.

10.414 The shedding, by discontinuance or sale, of some division of the
company's operations may affect identity. The decision of Walton J. in
*Rolls-Royce Motors Ltd v. Bamford* (1976) 51 T.C. 319 is persuasive
authority. In this context the correct analysis of para. (b) of s. 80E(1)
becomes critical. If the division that is shed from the company's operations
can, for purposes of para. (b), be seen as a business separate from another
business constituted by the activities that continue, the shedding will not
affect the identity of the business that continues.

10.415 The adding of new operations may affect identity. Again the
question of the correct analysis of para. (b) is raised. If the new operations
are seen as a separate business, they will not affect identity. There may of
course be a failure to meet the tests of para. (c), unless the business
constituted by the new operations is of a kind that was carried on before
the change. If the new operations are no more than the adding of new
products to those already sold, or produced and sold, identity ought not to
be affected, at least where the products are of a kind that existing
customers would expect the company to sell in carrying on its business. A
company publishing law textbooks that embarks on publication of school
textbooks may cause its business to change its identity.

10.416 If a company changes the method of its operations, identity ought
not to be affected. A business which sells for cash does not change its
identity if it commences to sell on credit terms. It will continue to operate within its existing goodwill. A change in method may however raise a question of the operation of the second limb of para. (c). The company may not have sold on credit terms at any time before the change in beneficial ownership of its shares, and it will be said that sale on credit terms is a new kind of transaction. There may be some help for the company in the view taken by Sheppard J. in *J. Hammond Investments Pty Ltd* (1977) 77 A.T.C. 4311 in the passage quoted in [10.405] above. He would limit the second limb of para. (c) to transactions of an isolated kind that are not “daily transactions” in carrying on a business.

10.417 The company may engage in business operations, in the year of claimed application of the loss, which involve shifting of income into the company from an associate. The company will buy from the associate at a substantial discount, and sell in its normal outlets. Such a change in method of operations still leaves the company operating within its existing goodwill, and identity of business is presumably not affected. And the observations of Sheppard J. in *J. Hammond Investments* may afford a reply to an argument that purchasing from the associate involves a new kind of transaction such that there is a failure to meet the test in the second limb of para. (c). Alternatively, it would be said that the identity of the person who is the other party to a transaction does not go to the question whether the transaction is of a different kind.

10.418 Income shifting operations, it was seen in [10.393]–[10.394] above, may attract the operation of s. 80DA so that loss carried forward is prima facie denied, even though subss (1) and (3) of s. 80A do not apply to bring about a prima facie denial. In which event the question in the last paragraph as to the operation of s. 80E is raised, and the broader question as to the correlation of s. 80DA and s. 80E discussed in [10.399]–[10.400] above.

10.419 The effect on identity of business of the acquisition of goods in the course of income shifting is an aspect of a wider question of the effect of a change in the source of supply of goods. *Gordon & Blair Ltd v. I.R.C.* (1962) 40 T.C. 358 is persuasive authority that a company which ceases to manufacture goods, though it continues to market goods of the same kind, now obtained from another, does not carry on the same business. The supplier may be an associated company that has acquired the manufacturing operation. The correct analysis of para. (b) is again raised. If the analysis in *Boyded (Holdings)* is adopted, it may be possible to say that manufacturing was a distinct business and the cessation of manufacturing does not affect the identity of the business of distributing. Whether or not manufacturing was a distinct business will need to be
answered by reference to the existence of a distinct management and staff structure, and distinct accounting.

10.420 Clearly the question whether a business after the change is the same as a business before the change, a question raised by para. (b), is distinct from the question raised by the first limb of para. (c), whether a business after the change is of the same kind as a business before the change. A business may be of the same kind as a business carried on before the change even though it operates within a different goodwill. The scope, though probably not the size, of operations will, however, be relevant. A business after the change that lacks a division that was part of a business before the change may be of a different kind. And the same may be said where a business after the change has a division that was not part of a business before the change.

Subdivision B of Division 3 of Part III (sections 82AA-82AQ): investment allowance

10.421 Subdivision B of Div. 3 of Pt III provides for a deduction of a fraction of capital expenditure on a new unit of eligible property (s. 82AB). “Eligible property” is defined in s. 82AQ to mean “plant or articles within the meaning of s. 54”. There are, however, a number of exclusions. Thus structural improvements, subject to some exceptions, are excluded (s. 82AE). The availability of the deductions is subject to a number of conditions, and there is a time limit on availability prescribed by s. 82AB.

10.422 The deduction is allowable, in respect of expenditure on a unit of property, notwithstanding that a deduction is allowable in respect of that unit of property under another provision of the Act, save where it is allowable under ss 70A, 75C, 75D, 122J, 123B or 124AH (s. 82AM). For this reason it is appropriate to treat the deduction as allowable in respect of notional expenditure. Its effect is to give tax relief as an incentive to encourage investment expenditure.

10.423 The availability of the investment allowance reflects a current Government policy. It is not part of the basic structure of the income tax, and the detail of the allowance is not further pursued in this Volume.

Section 102C: deduction for a deemed payment where income that has been transferred to another is treated for tax purposes as if the transfer had not been made

10.424 Division 6A of Pt III requires that, in some circumstances where there has been a transfer of a right to receive income from property, the income is to be treated for tax purposes as if the transfer had not been made.
The circumstances involve a transfer of the right to receive income for a period that will terminate before the seventh anniversary of the date on which income from property is first paid to, or applied or accumulated for the benefit of, the transferee.

Treating the income as if the transfer had not been made is intended to produce the consequence that the income is income of the transferor. Section 102C is intended to produce the further consequence that the transferor is entitled to a notional expense, reflecting a payment that he might have made to the transferee had he not transferred the right to receive the income. An amount equal to an amount of income in fact paid to the transferee, or applied or accumulated for his benefit, under a transfer that s. 102B requires should be treated as not having been made, is deemed to have been paid by the transferor to the transferee for the purpose for which the right was transferred. The deductibility of the notional expense will depend on the operation of other provisions of the Act, including s. 51 (1), on a payment made for that purpose. Where the transfer was made for the purpose of rewarding a person for services rendered, there may be a deduction of the notional expense under s. 51(1), if a payment for that purpose would in the circumstances be relevant and working.

Division 6A of Pt III is further considered in Chapter 13 of this Volume.

Provisions Allowing Deduction of Expenses of Particular Industries

The Assessment Act contains a great number of provisions applicable only to particular industries, and many of these provisions create allowable deductions. Sometimes the particular industry provisions extend the operation of general provisions. Thus the definition of plant for purposes of the operation of the provisions allowing deductions for depreciation is extended by s. 54(2) to include certain structural improvements on land which is used for the purposes of agricultural or pastoral pursuits, certain structural improvements on land that is used for the purpose of forest operations, and certain structural improvements which are used for the purposes of pearling operations and are situated at or in the vicinity of a port or harbour from which those operations are conducted.

Other particular industry provisions do not extend the operation of the general provisions, but provide specially for deductions. Thus special provision is made in Div. 10C of Pt III so as to allow what is in effect depreciation of buildings used in the travel industry. Special provision is
made in Subdiv. B of Div. 10A of Pt III so as to allow what is in effect
depreciation of buildings used in carrying on a business of milling timber.

10.429 Some of the particular industry provisions allow deductions which
are different in kind from any deductions allowable under general
provisions. A taxpayer engaged in a business of primary production is
entitled to deductions of a wide range of expenses that would not be
deductible under s. 51(1). Some of these expenses are deductible over a
period of years, for example those dealt with in s. 75A. Others are
deductible in the year in which they are incurred, for example those dealt
with in ss 75B and 75D. Special deductions are available to taxpayers
engaged in some aspect of the timber industry, for example under s. 124F
or s. 124J. A special deduction which includes an element of notional
expense of the kind allowable under the investment allowance provisions
referred to in [10.421] and [10.423] above is available in respect of an
investment in Australian films (Div. 10BA of Pt III). A life insurance
company is allowed a special deduction in respect of the actuarial value of
its liabilities (ss 114 and 115).

10.430 Some industries are subject to provisions which seek to provide a
special regime for some aspects of the industry's operations, to a degree
displacing the general provisions. Thus special regimes apply to the
deduction of expenses of general mining, the transport of minerals and
petroleum mining (Divs 10, 10AAA and 10AA of Pt III). The expenses
would in most instances not be deductible under the general provisions.
The exclusiveness of each special regime is in any case established by a
section denying deductions under other provisions where deductions are
allowable under the relevant Division (s. 122N, in relation to general
mining, s. 123E in relation to transport of minerals, and s. 124AN in
relation to petroleum mining). In relation to general mining and petroleum
mining the exclusiveness of the special regime is qualified by provisions
which give the taxpayer an election to have the general depreciation
provisions applied to expenditure on plant (s. 122H in relation to general
mining, and s. 124AG in relation to petroleum mining).

10.431 The provisions allowing deduction of expenses of particular
industries are not further considered in this Volume.
Part III: Tax Accounting
Chapter 11: Accounting for Receipts and Outgoings

Introduction

11.1 In [2.10]–[2.37] above, the integral relationship between the income character of an item and the derivation of that item was emphasised. Proposition 3, considered in [2.34]–[2.37] above, asserts that the character of an item as income must be judged in the circumstances of its derivation by the taxpayer, and without regard to the character it would have had if it had been derived by another person. While the Assessment Act in s. 25(1) refers to “income derived”, derivation is itself an aspect of income character. The same observation may be made in another way. Derivation is concerned with the time at which an item is income, so that it falls to be included in a return of income for a year of income or comes to be subject to tax by withholding. But the time at which an item is to be judged for its income character will affect the judgment that is made. In Abbott v. Philbin [1961] A.C. 352, a decision that there was a derivation on the acceptance by the taxpayer of the options offered to him was the basis of a conclusion that there was an item of an income character. A decision that the only derivation occurred on the exercise of the options would have required a conclusion that there was no item of an income character. The shares acquired on exercise came to the taxpayer as a consequence of the exercise of a valuable right, and not in circumstances which gave them an income character. In Constable (1952) 86 C.L.R. 402 the employer's contributions to a superannuation fund were, in the view expressed by the majority of the court, not derived by the employee at the time they were contributed to the fund in respect of the employee. They were derived on payment out from the fund to the employee, at which time they had ceased to have an income character as rewards for services he had performed.

11.2 None the less it is necessary in any discussion of tax accounting to follow the language of s. 25, so as to sever the notion of derivation from the income character of an item. So too it is necessary to follow the language of s. 51 so as to sever the incurring of an item from the character that makes it a deductible item.

11.3 The problems of tax accounting are thus seen as problems of when an item is “derived” or “incurred”. Problems of derivation may in all circumstances be regarded as problems of interpretation of the word “derived” in s. 25, if the central provision and single meaning analyses of the structure of the Assessment Act, propounded in [1.30]–[1.44] above, are adopted. That interpretation will be assisted by the language that is
used in specific provisions which may direct a particular basis of tax accounting, for example s. 44(1) which refers to a dividend “paid to” the taxpayer, or may provide a particular basis of accounting for an item, for example s. 36 which brings in the value of an item of trading stock disposed of otherwise than in the course of carrying on a business.

11.4 Problems of incurring will for the most part be problems of interpretation of the word “incurred” in s. 51(1). Sometimes, however, deductibility depends on some provision which cannot be seen as simply explaining the operation of s. 51(1). In which case the timing of incurring must depend on the interpretation of that provision. Section 59(1), in regard to the deduction that may be available on disposition, loss or destruction of property in respect of which depreciation has been allowed, is an illustration.

**Tax Accounting and Financial Accounting**

11.5 It will be seen that tax law, in asserting principles determining the time of derivation of a receipt of income that is not a profit item, and in determining the time of incurring of an outgoing (as distinct from a loss), has adopted language borrowed from financial accounting which distinguishes between “accruals” or “earnings” or “credit” accounting, and “cash” accounting. It should not, however, be assumed that financial accounting is part of tax law. Accruals financial accounting will, for example, treat as an expense a provision for long service leave. Accruals tax accounting will not allow a deduction of such a provision (Nilsen Development Laboratories Pty Ltd (1981) 144 C.L.R. 616 and s. 51(3)). Financial accounting may treat a “pre-payment” as an expense only to the extent that the benefit from the payment is enjoyed in the year in which it is treated as an expense. Tax accounting will, it seems, treat the outlay as a deductible outgoing in the year in which it is in other respects incurred. The matter was the subject of some comment in [6.119]–[6.136] above.


11.6 Tax accounting has none the less imported some principles from financial accounting. The principal illustration is the principle in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314 that an item of income otherwise derived will be treated as derived only to the extent that it has been “earned”. The principle may have a scope narrower than its scope in its application in financial accounting, but it is none the less imported. The
consequence, it will be seen, is a curious asymmetry between tax accounting for income items and tax accounting for deduction items.

The Basic Distinction: Accounting for Receipts and Outgoings and Accounting for Specific Profit or Loss

11.7 Though somewhat grudgingly, tax accounting has come to recognise a basic distinction between accounting for receipts and outgoings and accounting for specific profit or loss. Assertions that were commonly made to the effect that tax accounting under the Assessment Act was a matter of accounting for receipts and outgoings except where the Assessment Act specifically provided otherwise are no longer heard, though assertions continue to be made which would regard accounting for profit or loss as exceptional and accounting for receipts and outgoings as the general rule. Specific provisions of the Assessment Act, the most significant being s. 26 (a) (the predecessor of s. 25A(1)) had always required profit or loss accounting. *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347 involved a recognition that items which are income by ordinary usage might be accounted for on a specific profit basis, though there had been such a recognition as far back as *New Zealand Flax Investments Ltd* (1938) 61 C.L.R. 179 as a matter of observation by Dixon J. And there had been recognition in the decisions in *Australasian Catholic Assurance Co. Ltd* (1959) 100 C.L.R. 502 and, though implicitly, in *Investment & Merchant Finance Corp. Ltd* (1971) 125 C.L.R. 249 and in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106 and the so-called banking and life insurance cases concerned with profits on investments. The most recent recognition is by the High Court in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355, though it is again implicit: the court was not asked to consider questions of tax accounting. The recognition is in the conclusion that the item of income by ordinary usage arising from the isolated business venture carried out by the taxpayer was of the same kind as the item of income that might arise under s. 26(a).

11.8 At a number of points in Pts I and II of this Volume situations are identified where the appropriate accounting is concerned with what might be called a specific profit or loss. A number are listed in [5.15] above, and some of these are the subject of further comment in other paragraphs, more especially those concerned with losses in relation to receivables and liabilities ([6.308]ff. above). An addition to the list would be an isolated business venture, as in *Whitfords Beach*. All these situations are “instances of special businesses and transactions . . . where nothing but the net profit could be regarded as a revenue item”, which Dixon J. in *New Zealand Flax*
Investments Ltd (1938) 61 C.L.R. 179 at 206 anticipated might be found. They do not include the situation of dealing in trading stock as defined in s. 6. It was explained in [5.23]ff. and [7.17]ff. above that a code of accounting for dealings in trading stock has been adopted by express provisions in ss 28ff. That code in its terms adopts receipts and outgoings accounting, but adapts that accounting so that it achieves much the same as would be achieved if specific profit or loss accounting had been left to apply.

11.9 There is one common feature of the listed situations. There has been a cost in the form of an outlay in the acquisition of a revenue asset, or in the discharge of a liability on revenue account, and the asset is realised to yield proceeds or there have been proceeds from the assumption of the liability. Profit or loss which is the item of income or deduction is the positive or negative balance of proceeds over cost. This common feature yields a principle which will go to determine the boundary between the regimes of specific profit or loss accounting and receipts and outgoings accounting. The principle would assert that the cost of acquiring a non-wasting revenue asset, or of discharging a revenue liability, is not an outgoing deductible under s. 51(1). It is not an outgoing: it is no more than an outlay. And the proceeds of a non-wasting revenue asset or of a liability on revenue account are not a receipt that is income. The relevant item of income or loss will be the balance—positive or negative—of proceeds over cost. The principle is thus expressed in terms of a non-wasting asset. A non-wasting asset, for this purpose, is an asset whose value is not consumed in some process of derivation of income which is not simply the acquisition and realisation of the asset. The assets in *London Australia Investment* were clearly non-wasting. Receivables on revenue account are non-wasting. The land in *Whitfords Beach* is non-wasting.

11.10 Specific profit or loss accounting may have a wider regime than the regime set by the principle considered in the last paragraph. A like principle might be framed applicable to wasting assets—assets whose value is consumed in a process of income derivation that is not simply the acquisition and realisation of the asset. The principle would need to accept that at least some part of the cost of a wasting revenue asset is an outgoing that is deductible. The outlay in *B.P. Australia Ltd* (1965) 112 C.L.R. 386 was for the acquisition of a wasting revenue asset—a tie agreement whose value would diminish over the period that goods were supplied under the tie. The conclusion in *B.P. Australia* was that the whole outlay in the acquisition of the tie was an outlay deductible immediately. In a number of contexts in Pt II, it was argued that an outlay on a wasting revenue asset should be treated as a deductible outgoing only as and to the extent that the
value of the asset is consumed in the process of income derivation ([6.119]–[6.136] above). The argument was there made in relation to the facts of B.P. Australia itself, and in relation to the facts in Ilbery (1981) 81 A.T.C. 4661, that interest paid in advance should be treated as a deductible outgoing only as and to the extent that the use of the money for which the interest is a payment is enjoyed. An outlay in acquiring an import quota or an agency should be treated as a deductible outgoing only as and to the extent that the period to which the quota or agency relates has elapsed. An outlay for insurance cover extending over a number of years should be treated as a deductible outgoing only as and to the extent that the cover has elapsed. If the argument is accepted there will be a wider regime for profit and loss accounting. A taxpayer who is bought out of an agency agreement that is a revenue asset will receive proceeds of realisation which are income only to the extent that they exceed so much of the cost of the agency agreement as has not been a deductible outgoing.

11.11 This extended regime for specific profit or loss accounting will of course only operate where the outlay is to acquire a wasting revenue asset. It was argued in relation to Ilbery, in [6.116] above, that the advance payment of interest secured a lasting advantage that was a structural asset, and the payment was a non-working expense. A payment for long term insurance cover may be characterised in the same way. The payment in Strick v. Regent Oil Ltd [1966] A.C. 295 was held to be a structural expense. In all these instances any proceeds of realisation of the asset which is the lasting advantage will be proceeds of realisation of a non-revenue asset and, unless some specific provision of the Assessment Act applies, a profit that is income or a loss that is deductible cannot arise.

11.12 Specific profit accounting achieves a matching of expenses and receipts by deferring any allowance for the cost of an asset until a calculation of specific profit or loss falls to be made. It may require in some circumstances that an anticipated receipt be brought into the calculation of a profit or loss though the receipt would not yet be brought to account if receipts and outgoings accounting were applicable. The matter of bringing in an anticipated receipt in specific profit accounting is the subject of later discussion in relation to building contracts. Bringing in an anticipated receipt and the allowance of costs at that time will have the effect of advancing the time of realisation of a profit. In another aspect specific profit accounting may be flexible in delaying the time of realisation by requiring that receipts be brought to account and a profit or loss determined only when there are actual cash receipts—as distinct from the arising of receivables. There may be held to be a realisation to the extent of the proportion that cash receipts are of the amount of the
receivable, or to the extent that total cash receipts have come to exceed cost. It will be apparent that the timing and extent of realisation will be different depending on which method of specific profit accounting is adopted, though each method may be described as a method of determining “profit emerging” or “profit arising”. Indeed the same phrases may be used to describe the method of specific profit accounting referred to above, which may be applied to a building contract. Specific profit accounting is thus flexible, though it may be indeterminate.

11.13 Receipts and outgoings accounting may claim some achievement in matching receipts and outgoings. Any achievement within its general field of operation is the outcome of the decision in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314. In its special application, by ss 28ff., in trading stock accounting, its achievement also depends on what is in effect the deferral of the deduction for a deemed outgoing of the cost of trading stock (s. 51(2)) by the operation of s. 28, so that the outgoing is allowed when the item of trading stock ceases to be on hand and there is, at least generally, a matching receipt of the proceeds of realisation. The achievement of receipts and outgoings accounting in its general field of operation will be limited while recognition is refused of a principle that will treat an outgoing as incurred only as and when it is consumed—as and when a benefit that results from the outgoing is consumed in the income producing operation.

11.14 Receipts and outgoings accounting does not have the flexibility of specific profit accounting. Where accruals accounting is applicable there will, subject to the *Arthur Murray* principle, be a derivation of income when there comes to be a right to receive an ascertained amount and there is no element of contingency. The amount, it seems, need not be presently receivable. There is no room for a method of accounting which would parallel profit-emerging in specific profit accounting. Any such method was rejected for Australian law in *J. Rowe & Son Pty Ltd* (1971) 124 C.L.R. 421, a case that has been followed for New Zealand law in *Farmers' Trading Co. Ltd v. C.I.R. (N.Z.)* (1982) 82 A.T.C. 6001. *Rowe* concerned trading stock accounting, where a special statutory regime has displaced specific profit accounting by receipts and outgoings accounting. It might be taken to have established the law even more firmly for receipts and outgoings accounting in its general field of operation.

11.15 The matching of receipts and outgoings that results from the *Arthur Murray* principle had not been recognised at the time of the High Court decision in *New Zealand Flax Investments Ltd* (1938) 61 C.L.R. 179. The latter case offered a stark demonstration of the rogue operation of receipts and outgoings accounting in the absence of an *Arthur Murray* principle.
Dixon J. observed (at 199):

“If there is any ground upon which the plan adopted for conducting the operations of New Zealand Flax Investments Ltd may be extolled, it must be for the manner in which it illustrates the difficulty of applying the provisions of the federal income tax law when a transaction takes more than a year to complete and the true profit arising from it cannot be ascertained until it is completed or carried further towards completion than a year allows. In such cases a satisfactory estimate of the position at the end of a year may often be made, but upon commercial principles. If that is done, a suitable provision for future outlay must be made against current receipts or credits. But under the Income Tax Assessment Act 1922–1930, the assessment must begin by taking, under the name of assessable income, the full receipts on revenue account, and only such deductions must be made as the statute in terms allows. At all events that is the interpretation which the statute has received in this court.”

The High Court was not asked in New Zealand Flax Investments to consider the recognition of a principle that would have deferred the derivation of receipts for the “bonds”, so that there would have been derivation of those receipts as the work which the taxpayer had undertaken to carry out under the agreement expressed in the bonds progressed. Starke J. (at 197) observed that the court “inquired whether the sum . . . received from the sale of bonds was income. . . . The only answer the court received was that the Act taxes the gross income of the taxpayer—all that comes in—subject to certain statutory deductions and, in any case, that the matter was not raised by the objections to the assessment.” His comment on that answer is significant. He said: “The former answer overlooks the fact that the [Act] imposes a tax upon income. It is not a tax upon everything that comes in whether an income receipt or a capital receipt.” That comment may suggest a willingness to consider an Arthur Murray principle. On the other hand, it is framed in terms of “capital” receipt, and may only indicate the possibility that some of the receipts by the taxpayer were not income because they were contributions to capital. As that principle is explained in [2.113]ff. above, it might have denied an income character to the receipts so far as they were to be used in paying for the land that was to be vested in the bondholder. The taxpayer would, in turn, have been denied any deduction for what it paid for the land. But the contribution to capital principle would not have denied an income character to other receipts under the bonds.

11.16 There is a reservation about the income character of receipts under the bonds in the words “assuming the proceeds of the bonds to be a revenue item” in the judgment of Dixon J. (at 204). But the reservation is not explained. Instead, Dixon J. concentrated on extracting from receipts and outgoings accounting as much as he could that would achieve some measure of matching of receipts and outgoings. The achievement was very little, and at some cost to the coherence of receipts and outgoings accounting. Accruals was presumably appropriate. Yet Dixon J. treated only cash receipts as derived. At the same time he allowed deduction of so-called “interest” on money received under the bonds, though that interest had not been paid and liability to pay was clearly still contingent.
11.17 In *New Zealand Flax Investments* receipts ran very much ahead of outgoings, and the problem of matching was a problem of deferring receipts. There will be other circumstances where matching requires a deferral of outgoings. The scope that the law may allow to achieve matching by deferral of outgoings remains unresolved. In yet other circumstances matching may require the advancing of an income derivation or the advancing of an outgoing. Receipts and outgoings accounting admits of neither: *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616. In these respects receipts and outgoings accounting may simply share an incompetence with specific profit accounting. In the New Zealand case, *H. W. Coyle Ltd v. C.I.R. (N.Z.)* (1980) 80 A.T.C. 6012 the taxpayer sought the application of specific profit accounting to a building contract, asserting that no profit emerged until he had completed work under the contract. The New Zealand Revenue sought another method of specific profit accounting—a percentage of completion method—that would have required bringing to account receipts which were as yet only contingent. To bring those receipts to account would have involved some affront to a financial accounting convention that an unrealised profit should not be recognised. The New Zealand court rejected both methods of specific profit accounting put to it, and applied receipts and outgoings accounting tempered by the *Arthur Murray* principle.  

11.18 The advancement of costs in specific profit tax accounting would not offend financial accounting. It might be assumed that in the facts of *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 development costs had been incurred in the form of wages of employees engaged in the development work. Those wages were a cost to be brought to account in the determination of the profit emerging on the sale of the developed land. Presumably a provision for long service leave to which those employees had acquired an entitlement would also be a cost to be brought to account. *Nilsen Development Laboratories* and s. 51(3) do not stand in the way. They are concerned only with receipts and outgoings accounting.  

11.19 Tax accounting for profit or loss is concerned with specific profit or loss, and not with the overall consequence of operations during a year of income which will be reflected in taxable income, or in financial accounting, in a balance of a profit and loss account. Reference has already been made ([6.296] above) to the confusion in some expositions of the Australian income tax law which would assert that the law differs from the United Kingdom law which is concerned with the “profits of a trade”. One view of the United Kingdom law equates profits of a trade with the balance of a profit and loss account. Out of this view there is drawn a conclusion that much of the United Kingdom law is irrelevant if it is sought to use it as
persuasive authority in Australian law. The United Kingdom law, it is said, accepts a figure determined by accounting conventions save where some specific provision of the law requires a correction. It will already be apparent that a great deal of United Kingdom income tax law has been imported into the Australian law. And where there is no specific provision of statute, the United Kingdom law has been created by judicial decision, with what assistance judges might choose to take from accounting conventions. The ultimate question is always whether an item is income, or as it will often be put where a business is involved, a profit of a trade. The fact that an item may have entered the calculation of a balance of profit or loss for purposes of financial accounting does not determine any consequence for United Kingdom income tax.

11.20 Another view of the United Kingdom law places emphasis on the express reference to “profits” in the phrase “profits of a trade” and in like phrases used in the United Kingdom legislation, and would assert that there is a basis in United Kingdom law for treating a profit in the sense of a balance of proceeds over cost of some asset as an item of income, and no such basis in Australian law, save in some specific provisions such as s. 25A(1). The word “profits” in the phrase “profits of a trade” in the United Kingdom law and in other contexts is intended to cover all income items. It will cover a simple receipt and a balance of proceeds over cost. It affords no basis for a view that the United Kingdom law is concerned with income by ordinary usage, and distinct items called profits.

11.21 It is true that the view of Australian law that it taxes only simple receipts except where some specific provision provides for taxing a profit, has lost some support. The loss of support became very evident in *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347. The view none the less lingers: a frank recognition that the view is unsound would allow an open development of the law defining the regimes of receipts and outgoings and specific profit or loss accounting.

11.22 Accounting for receipts and outgoings and accounting for specific profit or loss are two distinct regimes. The law in relation to receipts and outgoings is concerned with the timing of a receipt, which will involve issues as to receivability if accruals accounting is held to govern, or actual receipt if cash is held to govern, and as to a requirement of earning which may cause derivation, otherwise complete, to be deferred. And it is concerned with the timing of an outgoing which will involve parallel issues, save that there may not be a requirement of consumption parallel with the requirement of earning.

11.23 The law in relation to specific profit or loss is concerned with the time of realisation and the calculation of a profit as it emerges from some
isolated business venture, or from some particular transaction which may or may not be an aspect of some continuing business operation. The law as to derivation of a receipt and incurring of an outgoing applicable where a receipts and outgoings regime is applicable, has no direct bearing on the recognition of costs and proceeds in the calculation of a specific profit or loss. Indeed specific profit or loss accounting may need different rules to determine the time of realisation of a loss, from those applicable to the time of realisation of a profit. Where a taxpayer has sold an asset for less than he paid for it, but has not yet received payment, he will wish to assert that he has realised a loss, even though, had he sold for more, he might have asserted that the realisation of his profit must wait on actual receipt of the proceeds of sale. It is possible that he will be successful in his submission. Where profit or loss may arise from the discharge of a liability, a taxpayer may be anxious to assert that he has realised a loss when the time for repayment has arrived.

The Distinction between Accruals and Cash Tax Accounting

11.24 The law in relation to receipts and outgoings accounting generally concerns the appropriateness of one or other of accruals and cash accounting and the principles which express each basis. Broadly, accruals tax accounting and cash tax accounting correspond with methods of accounting under the like descriptions in financial accounting. There are, however, important differences. Accruals tax accounting is much less ready than accruals financial accounting to find that an outgoing has been incurred. Financial accounting may hold an expense has been incurred in the form of an obligation to provide long service leave to an employee, an obligation which will be expressed in a provision in the taxpayer's accounts. Tax accounting, on the authority of Nilsen Development Laboratories Pty Ltd (1981) 144 C.L.R. 616 and s. 51(3), will say that no outgoing has been incurred until actual payment is made for leave taken, or actual payment is made in lieu of leave not taken. Cash financial accounting may not always be concerned to deny that a cash receipt has been derived because it has not yet been earned, in a sense of that word drawn from Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314. But deferral till the receipt is earned is arguably the correct method of cash tax accounting. Arthur Murray involved a taxpayer obliged to account on an accruals basis, but the elaboration of the principle in the case, in particular the relevance of a prospect that money received may have to be returned if only in the form of damages for breach of contract, suggests that it is equally applicable to a receipt that is accounted for on a cash basis.
An item of receipt that is to be accounted for on an accruals basis is derived when it becomes “due”, though not necessarily presently receivable, and an item of outgoing is incurred when there arises a “definitive commitment to pay” (James Flood Pty Ltd (1953) 88 C.L.R. 492) though it need not be presently payable. An item of receipt that is to be accounted for on a cash basis is derived when it is actually received, though there is a notion of “constructive receipt”, and an item of outgoing is incurred when it is actually paid. Questions such as whether “due” involves legal recoverability, whether “definitive commitment to pay” involves legal liability and as to the scope of “constructive receipt”, are deferred for the present. The immediate concern is with the law that will determine which basis of accounting is applicable to an item.

The Appropriateness of each basis of Accounting

Where the Assessment Act does not in express terms indicate the appropriate basis of tax accounting in regard to any receipt or outgoing, the choice of basis must depend on judicially established principles. The leading case is C. of T. (S.A.) v. Executor Trustee & Agency Co. of S.A. Ltd (Carden's case) (1938) 63 C.L.R. 108. So far as any single governing principle emerges from Carden's case, it is that the basis of accounting must be chosen by reference to its “actual appropriateness”: it is a question of which basis of accounting most “truly reflects income”. On a more determinate level, Carden's case offers the rule that the cash basis is appropriate in regard to the proceeds of “professional skill and personal work”. Thus a wage-earner or salary-earner will bring his wages or salary to account on a cash basis. The case also suggests a rule that the accruals basis is generally appropriate whenever taxable income falls to be ascertained in relation to a period less than a full year of income. Dicta of Dixon J. in Carden's case support a rule that the accruals basis is appropriate wherever the computation of profits from manufacture or trading is called for, that is where there is “a stock of vendible articles to be acquired or produced and carried by the taxpayer, where outstandings on the expenditure side . . . correspond to, and are . . . naturally connected with, the outstandings on the earning side, and where there is . . . [a] fund of circulating capital from which income or profit must be detached for actual enjoyment” (at 158).

It will be seen in Chapter 14 below that the trading stock provisions of the Assessment Act allow a deduction of what will normally be the cost of the item when the item ceases to be on hand. This is the manner of operation of s. 28. Where an item of trading stock is sold on credit terms
there will be distortion of the taxable income of the year of sale if the proceeds of sale are accounted for on a cash basis (cf. *J. Rowe & Sons Pty Ltd* (1971) 124 C.L.R. 421). Accruals is thus the appropriate basis of accounting.

**11.28** The principle expressed in *Carden's case* (1938) 63 C.L.R. 108 is that a cash basis forms a fair and appropriate foundation for the estimating of professional income where “the receipts represent in substance a reward for professional skill and personal work to which the expenditure on the other side of the account contributes only in a subsidiary or minor degree” (at 158). The principle may however be qualified by the observation later in the judgment of Dixon J. that “If in a given medical practice there is but little certainty about the payment of fees, I should have thought that a receipts basis of accounting would alone reflect truly the income and for most professional incomes it is the more appropriate” (at 159). This observation about bad debts experience is not referred to in the judgment of Barwick C.J. in *Henderson* (1970) 119 C.L.R. 612, though he does refer to the figure for bad debts, a relatively small figure, in the accounts of the partnership of accountants in that case. Barwick C.J. was content to assert the “sharp contrast” between the operation of the partnership of accountants in *Henderson* and the operations of the medical practitioner in *Carden's case* and, by inference, to assert that the operations of the partnership in *Henderson* did not amount to a “professional practice carried on by the taxpayer[s] personally” while the operations of the doctor in *Carden's case* did amount to a professional practice carried on personally. The Commissioner, in an announcement subsequent to *Henderson*, (CCH, *Federal Tax Reporter*, para. 12–130) expressed the Department's view in this way:

> “As the Commissioner at present views the position, the considerations which led the court to conclude that the true income of the firm of accountants involved in *Henderson's case* could not be accurately ascertained unless debtors are taken into account would be equally applicable to other accountants, solicitors and other professional men who provide professional services as a business.” . . .

> “Until the position is clarified by further decisions, there will be no changes in the departmental practices for arriving at the taxable incomes of barristers, who usually have no right to sue for their fees until they are received, or of doctors, dentists, etc. who might be thought to be providing personal services rather than carrying on businesses, and whose cases do not therefore fall within the terms of the *Henderson decision*” (emphasis added).

**11.29** There is an indication in the reference to the situation of a barrister that the probable bad debts experience of the taxpayer may continue to be relevant. The announcement otherwise assumes that the outcome in
Henderson is that accruals will be appropriate if the professional practice is carried on as a business. The clue to the distinction may be in the extent to which the professional practice makes use of the services of employees. In Henderson a very substantial part of the disbursements of the practice must have been made up of salaries to employees and the total disbursements, for example in the 1965 year, were $1,045,358 while the fees earned for that year were $1,181,166.

11.30 One can suggest a reason why cash rather than accruals may be the more appropriate when the taxpayer is likely to have substantial bad debts. If he were on an accruals basis, the deduction under s. 63 for bad debts written off may not afford sufficient scope to correct the distortion of taxable income which might result. It is not however readily apparent why accruals rather than cash is the more appropriate when a professional practice is carried on as a business in the sense suggested by the facts of Henderson. The reason may be that a professional practice so carried on may be expected to have substantial outgoings which, whether accounted for on a cash or accruals basis, will run ahead of the derivation of income. If the taxpayer is on an accruals basis the derivation of income will be sooner than if he is on cash, and is thus more likely to be accounted for in the year matching outgoings were incurred.

11.31 Henderson (1970) 119 C.L.R. 612 is not authority that every solicitor must account in relation to his professional practice on an accruals basis. In Firstenberg (1976) 76 A.T.C. 4141 at 4152 McInerney J. concluded “that in the case of a one-man professional practitioner the essential feature of income ‘derived’ is receipt”. His reasons for reaching that conclusion go very little further than an assertion of the inappropriateness of accruals in the circumstances of the taxpayer's practice. “I am of the view that the ‘accruals basis’ is, in the case of a practice such as the taxpayer's, an artificial, unreal and unreasonably burdensome method of arriving at the income derived” (at 4155).

11.32 Carden's case asserted a general principle that the accruals basis of accounting is appropriate where the accounting is for a “broken period”, in that case the period from the end of the last complete year of income until the taxpayer's death. No reason is suggested in the judgment why accruals is more appropriate in that situation. Indeed, an insistence by a personal representative that accruals is appropriate to the broken period to the date of death, may secure a tax advantage. Section 101A discussed in [11.150] ff. and [11.188] below would not bring in accruals of the last complete period which were received as cash in the broken period, and may not bring in accruals of the last complete period received in cash after death. The latter may not be “amount[s] which would have been assessable
income in the hands of the deceased person if [they] had been received by him during his lifetime”. They are amounts that would have been assessable income if received in the last complete period.

11.33 Judicial statements on the appropriateness of a basis of accounting, made in Carden’s case appeared to leave it open to the Commissioner to argue that the choice by him of a basis of accounting must be accepted if it is an appropriate basis, even though it is not the more appropriate basis. It would now appear from Henderson that there is only one appropriate basis of accounting, and this is determined by the law. However the law, both in this determination and when defining the principles of accounting attracted by the determination, is ready to look to established principles of financial accounting.

11.34 The Commissioner, it appears from the announcement referred to above, will allow a small retailer to account on a cash basis. Having regard to Carden’s case (1938) 63 C.L.R. 108 and J. Rowe & Sons Pty Ltd (1971) 124 C.L.R. 421 and to the trading stock provisions of the Assessment Act, it is not easy to see how this is justified.

11.35 There are no Australian authorities as to the appropriate basis of accounting when services, other than professional services, are provided. Presumably, if there are substantial outgoings involved, more especially if these are wages of employees, an accruals basis is appropriate. The authorities in regard to professional services all concern services provided in an independent contractor relationship. The cash basis of accounting is, presumably, always applicable when services, professional or otherwise, are provided in an employment relationship.

11.36 Farnsworth (1949) 78 C.L.R. 504 is a decision that in regard to some activities of primary production, cash is the appropriate basis. Dawson v. Botten (1952) 10 A.T.D. 252 is perhaps sufficiently explained on the ground that there had not been an accrual: the price receivable from the marketing authority for wool submitted for appraisal had not yet been ascertained. But Crisp J. appears at one point to contemplate that cash is the appropriate basis whenever goods are sold through a marketing authority. The case demonstrates how the trading stock provisions, in their object of bringing about a matching of costs and proceeds of sale, are subject to defeat even when accruals apply, if goods are no longer on hand and the price is not yet ascertained. If cash is the appropriate basis of accounting, the prospects of defeat are so much greater.

11.37 A taxpayer may in regard to some items be on a cash basis notwithstanding that generally he is on an accruals basis. Thus it seems that interest, even though it is, for example, on an overdue account for goods supplied, is to be brought to account on a cash basis. And other items of
passive income, including rent and royalties, will generally be brought to account on a cash basis. Where however there can be said to be a business of deriving interest, rent or royalties, accruals will be appropriate: *National Bank of N.Z. Ltd v. C.I.R. (N.Z.)* (1977) 77 A.T.C. 6001. Dividends will, presumably, always be accounted for on the special statutory basis, equivalent to cash, provided for by s. 44(1).

11.38 A taxpayer may be on a cash basis in regard to the derivation of an income item, for example interest received, even though another taxpayer in regard to the corresponding deduction item, for example, interest paid, is on an accruals basis.

11.39 An annuity receipt will generally be brought to account on a cash basis. Where however the amount is received from the trustee of a trust estate, there may be problems arising from the special tax accounting basis which is applied by s. 97 of the Assessment Act to a beneficiary in a trust estate. Where the annuity involves a present entitlement to income of a trust estate, s. 97 will presumably be applicable to the exclusion of any general principle of tax accounting.

11.40 The suggestion was made in [11.30] above that the appropriateness of accruals basis, where a taxpayer providing services has substantial outgoings for salaries of employees, rests on the fact that accruals may achieve some degree of matching. The extent of matching is very limited. A substantial degree of matchings would require the deferral of outgoings that concern work in progress until there are receipts resulting from that work. Accruals accounting could only bring about matching of this kind if the trading stock provisions were held applicable: there would appear little possibility of this. Even if a principle were accepted that an outgoing is not deductible until it is consumed, there does not seem to be any room for the application of such a principle. Like the trading stock provisions, specific profit or loss accounting, if held applicable, would achieve a substantial degree of matching. But there would need to be an extension of the present regime of profit or loss accounting. It could not be said that the costs of work in progress are in any sense outlays in the acquisition of assets.

11.41 In *Henderson* (1970) 119 C.L.R. 612 the Commissioner argued that there should be an amount shown at the end of the first accrual year, and, indeed, of subsequent years, reflecting a deferral of costs of work in progress. The Commissioner was concerned to find some offset to counter the “fall-out” of items of income, which had accrued in earlier cash basis years, but were not derived in those years because they were not the subject of actual receipts. The “fall-out” consequences of a change in basis of accounting are examined in [11.71]–[11.72] and [11.213]–[11.215] below. The bringing in of work in progress at the end of the first accrual
year in the manner of closing trading stock under s. 28 of the Act would have achieved the offset, provided no opening stock entry had been allowed to the taxpayer. Barwick C.J. saw the Commissioner's submission as an attempt to insist on accounting for items of income that had not yet been derived, and in rejecting it asserted principles about derivation of an item on an accruals basis. Those principles are the subject of observations in [11.52] below. The significance of the Commissioner's submission, in asserting a principle ofdeferring costs of work in progress where services are performed, was passed over.

11.42 It will be apparent from preceding paragraphs that there is no principle that one basis of accounting must be held applicable to all the items derived or incurred by a taxpayer in the same year of income. The point becomes evident enough when the taxpayer is required to account on an accruals basis for items that are aspects of the conduct of a business, and to account on a cash basis for items, whether or not connected in some way with the business, that are items of passive income.

11.43 Interest derived from investments will generally be subject to accounting on a cash basis. Where the lending of money is an aspect of a taxpayer's business, such that the loans are revenue assets, interest on those loans will it seems be subject to accounting on an accruals basis. This may be the consequence of the New Zealand Court of Appeal decision in National Bank of N.Z. Ltd v. C.I.R. (N.Z.) (1977) 77 A.T.C. 6001. The principle of that case may extend to a taxpayer who trades in debts, to a life insurance company that invests in debts, and to a taxpayer that engages in a business of investing involving the switching of investments. The last situation was the facts, as understood by Gibbs J., in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106.

11.44 Where a taxpayer carries on a business, one judgment will be made as to the appropriate basis of accounting in regard to all items that are active income of that business. But a taxpayer may carry on more than one business, and the appropriate basis of accounting must be separately determined for each business. The question whether business activity may include more than one business has been referred to on a number of occasions in earlier paragraphs, and the suggestion has been made that geographical separation, separate accounting or separate management may require a conclusion that there are several businesses, even though the activities of all the businesses are of the same general kind. A conclusion that there is a separate business is significant not only in relation to the appropriateness of a basis of accounting, but also in regard to the operation of the principle of contemporaneity in the interpretation of s. 51(1) as demonstrated in Ronpibon Tin N.L. & Tongkah Compound N.L. (1949) 78
C.L.R. 47, in regard to the operation of the principle that a receipt for a substantial detraction from pre-existing rights is not income and in regard to the principle that a receipt for giving up a structural asset of a business is not income.

11.45 If a taxpayer is held to conduct one business of selling and repairing motor cars, he will account on one basis, almost certainly on an accruals basis, for all items of active income of that business. If he carries on two businesses—a selling business and a repairing business—he might account in respect of one on an accruals basis and in respect of the other on a cash basis. If he is conducting only one business and discontinues the selling activity, the new circumstances may require a conclusion that he should cease to account on an accruals basis and hereafter account on a cash basis. In the result the consequences of a change in basis of accounting considered in [11.71]–[11.72] and [11.213]–[11.215] below will follow. A change from accruals to cash may involve what will appear to be a double inclusion in income of the same item. There is another possible analysis. The discontinuance of the selling activity, more especially if the repair activity is now carried on at a new location, may justify a conclusion that the business has ceased and that a new business has commenced. The tax accounting consequences of discontinuance of a business, considered in [12.99]–[12.108] below, will be attracted, but not the consequences of a change in basis of accounting.

The Meaning of Derivation of a Receipt when an Accruals basis is Appropriate

11.46 A receipt will be derived where the taxpayer is on an accruals basis in regard to the item, if an amount of money has become “due” to the taxpayer. It is not necessary that there should have been an actual receipt. An amount is clearly due if the taxpayer has a right to receive that amount presently, and there is no element of defeasibility or contingency affecting his right. There may be thought to be some element of doubt as to whether an amount has become due, if the right is not to receive presently but to receive at some future time. Crisp J. in Dawson v. Botten (1952) 10 A.T.D. 252 reserved the question whether the 95 per cent of the appraised value of the wool payable to the taxpayer on 1 July could be said to have been derived in the year of income in which the right arose. In Henderson (1970) 119 C.L.R. 612, Barwick C.J. did not commit himself to a general proposition that an amount is derived though the right is a right to receive at a future time. He said (at 650–651):

“In ascertaining such earnings, only fees which have matured into recoverable
debts should be included as earnings . . . I have used the word ‘recoverable’ to describe the point at which income is derived by the performance of services. I ought to add that fees would be relevantly recoverable though by reason of special arrangements . . . time to pay was afforded.”

11.47 The reference to “special arrangements” may suggest that derivation must wait until an amount is presently recoverable, if the taxpayer as a matter of general practice does business on terms that allow some time after completion of the work before the amount becomes presently recoverable. J. Rowe & Sons Pty Ltd (1971) 124 C.L.R. 421 may appear to be authority for the general proposition to which Barwick C.J. did not commit himself. But the case concerned the sale of trading stock on credit terms, and may have established a general proposition only in relation to receivables in respect of the sale of trading stock. Receipts and outgoings accounting applies to trading stock, because of express provisions in s. 51 (2) and ss 28ff. Treating the proceeds of sale as derived even though not presently receivable, will generally avoid a failure to match costs and proceeds which would otherwise result from the fact that the costs of stock in effect become deductible outgoings when the stock ceases to be “on hand”, and that may be a time when the proceeds of sale are not yet presently receivable. The High Court held that the element of the “cash price” reflected in each instalment to be received in the future was derived at the time of sale of the goods. The elements of interest in the instalments were derived, presumably, when each instalment was in fact received. Rowe has been followed by the New Zealand Court of Appeal in Farmers' Trading v. C.I.R. (N.Z.) (1982) 82 A.T.C. 6001, which reversed a decision that sought to defer derivation of amounts receivable in the future so far as they exceeded an amount that would equal the costs that, in effect, became deductible when the goods were sold. Neither case offers any support for a view that would treat the present value of amounts receivable in the future as derived at the time of sale, and would treat amounts beyond the present value as derived when they become presently receivable, or are actually received. A present value approach might be thought appropriate where no interest is expressly provided for in the terms of sale. It would not be appropriate where such provision is made, and where the transaction may then be seen as a sale for a price presently receivable which is received and lent to the purchaser at interest: the interest will be derived, a cash basis being applicable to it, as it is actually received.

11.48 The effect on derivation of the fact that the right to receive is defeasible is not the subject of any decision. In one sense, every right to receive is defeasible as the result of some new agreement between the parties. This circumstance cannot prevent derivation. A contract for the
sale of land may be voidable, and the right of the vendor to be paid may be
defeasible for this reason. If defeasibility is regarded as precluding
derivation, there will be no derivation until the ground for avoidance is no
longer available, or the contract is completed. If defeasibility does not
prevent derivation, there will be problems if the sale is in fact avoided.
There is need to find an outgoing available to the vendor that will reverse
the earlier inclusion of the amount receivable. The matter is the subject of

11.49 Where a taxpayer's right to payment is contingent, there is no
derivation until the contingency occurs. In Ballarat Brewing Co. Ltd
(1951) 82 C.L.R. 364, the debtor was entitled to a discount if he paid
within 30 days. There was no derivation of the amount of the discount,
until the 30 days had expired and the debtor had not made payment. It is
true that Fullagar J. based his conclusion on accounting conventions
allowing as an expense a provision for the discount that might be claimed.
But an explanation of the case in terms that the amount of the discount was
not income until the expiration of the time within which the discount was
available to the debtor, supports a principle that at least has an affinity with
Arthur Murray (N.S.W.) Pty Ltd (1965) 114 C.L.R. 314. The notion of
“earning” in that case should not require active steps to be taken by the
taxpayer. The view is taken in [11.111]–[11.112] and [11.203] below that
Arthur Murray is applicable, for example, to interest on money lent, so that
the interest is not derived until there has been a use of the money borrowed
for the period to which the interest relates. A like rule would apply in
regard to rent and other passive income.

11.50 The taxpayer's right to a receivable may be indefeasible and not
subject to any contingency. There will not however be a derivation by an
accruals basis taxpayer so long as the amount of the receivable is not
ascertained or presently ascertainable. This is one basis of the decision in
Dawson v. Botten (1952) 10 A.T.D. 252 and of the decision of those judges
in Farnsworth (1949) 78 C.L.R. 504 (Latham C.J. and Webb J.) who
considered that the taxpayer was properly to be assessed on an earnings
basis. In Dawson v. Botten, Crisp J. insisted that it was necessary that the
whole amount due to the taxpayer should be ascertained. It was not enough
that part of the “whole debt” of £4,472.16s.1d (being 95 per cent of the
appraised value), was due. It is not easy to see why it should be insisted
that the “whole debt” should be ascertained, or to see exactly what is meant
by the “whole debt”. Crisp J. referred to the case of Dailuaine-Talisker
Distilleries Ltd v. I.R.C. (1930) 15 T.C. 613 where the amount payable
depended upon adjustments which, it was provided in the contract, would
have to be made before the sum due could be finally determined. In the
circumstances no part of the amount receivable could be said to be ascertained. A conclusion that the amount is ascertained should not be precluded by the circumstance that the debtor is contemplating or has commenced an action for damages against the taxpayer arising out of the transaction from which the debt arose, or indeed has recovered damages. The incurring of an outgoing in the amount of the liability in damages is a distinct issue.

11.51 A receipt may be derived if the amount is ascertained or ascertainable at the time it is said to be derived. In *Farnsworth* an amount receivable from a marketing authority, which at the time could only be estimated, was held not to be derived. *Australian Gas Light Co.* (1983) 83 A.T.C. 4220 may support a view that the amount must be physically ascertainable. The taxpayer supplying gas could not read every gas meter at midnight on 30 June to determine how much gas had been consumed by customers. There was therefore no derivation in respect of gas used but not the subject of a meter reading prior to 30 June. So explained, the case is hardly consistent with *Commercial Union Assurance Co. Ltd* (1977) 77 A.T.C. 4186. That case is concerned, it is true, with incurring of outgoings on an accruals basis. Deductions were allowed in respect of claims on a taxpayer insurer in respect of liabilities not yet reported to the insurer. Another ground of decision in *Australian Gas Light* is more appropriate. The rate scale for gas supplied depended on the amount of gas supplied over a quarter. Whatever the quantity of gas consumed shown by a meter at 30 June, the amount payable in respect of that gas could not be determined until the next quarterly reading of the particular customer's meter, when the total gas consumed during the quarter could be known. Quarterly meter readings were staggered among consumers. So explained, the case is an application of *Farnsworth* and is consistent with the view taken in *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616 ([11.80]ff. below) in regard to the incurring of outgoings.

11.52 The language of “right to a receivable” in describing derivation by an accruals basis taxpayer has been adopted so far in this discussion. It is not intended, however, that right to recover should be confined to legal recoverability. It is true that in the passage quoted above ([11.46]) from the judgment in *Henderson* (1970) 119 C.L.R. 612, there is a dictum that “only fees which have matured into recoverable debts should be included in income”. From this dictum a conclusion has been drawn that legal recoverability is necessary if an amount receivable that is to be accounted for on an accruals basis is to be treated as derived. No doubt an amount that is legally recoverable will generally be an amount derived. But tax accounting should not be linked to a factor that may need to be finally
determined by litigation, perhaps litigation extending over years. The Papua-New Guinea Supreme Court in *Commonwealth-New Guinea Timbers Ltd v. Chief Collector of Taxes* (1972) 72 A.T.C. 4048 applied the dictum of Barwick C.J. with disastrous consequences for the sensible operation of the New Guinea law. A view is taken in [11.222]-[11.236] below that Australian law should follow United States' law by adopting a claim of right principle. Whether or not an amount is legally recoverable, it will be taken to be derived by a taxpayer who must account for it on an accruals basis, if other conditions are satisfied, when the taxpayer asserts a claim of right to recover the amount. If in a later year the taxpayer acknowledges that his claim was mistaken, or repays an amount he has in fact received, he will be entitled in that year to a deduction of the amount he acknowledges not to be recoverable or the amount he has in fact repaid.

11.53 A doubt that a claim to a receipt will be followed by an actual receipt does not prevent or qualify derivation. The New Zealand Court of Appeal so held in *National Bank of N.Z. Ltd* (1977) 77 A.T.C. 6001. The taxpayer's doubts may be expressed by writing-off under s. 63 the whole or some part of the amount derived as a bad debt, and a failure to obtain payment may give rise to a deduction for a loss under s. 51(1). *National Bank* resulted in a change in bankers' practice. Prior to that case the practice was that so much of an amount of interest receivable whose actual receipt was doubted would not be treated as income derived. Since the case the practice has become to include the full amount of interest receivable. *Commercial Banking Co. of Sydney Ltd* (1983) 83 A.T.C. 4208 at first instance demonstrates what might be thought an unexpected consequence: a loss experienced by the taxpayer in a failure to receive the full amount of interest receivable was held deductible even though that amount had never in fact been included as income derived in a return of income, the amount having become receivable before the decision in *The National Bank of N.Z. Ltd*. The decision is, in effect an application of the principle in *Country Magazine Pty Ltd* (1968) 117 C.L.R. 162. The amount was income derived in the earlier year, and the receivable was a revenue asset in relation to which a s. 51(1) loss deduction was available. The circumstance that the amount had not been included in assessable income of the earlier year could only be corrected, if the Commissioner had the necessary power, by amendment to the assessment of the earlier year.

11.54 It has been observed that a taxpayer may be on an accruals basis of returns in regard to some items but on a cash basis in regard to others. He may not be partly on accruals and partly on cash in regard to the same item: *National Bank of N.Z.* may be seen as authority for this proposition. And he may not be on accruals in regard to receipts and on cash in regard
to matching outgoings, or vice versa. This last proposition may be thought

to be at odds with New Zealand Flax Investments (1938) 61 C.L.R. 179.
The endeavour by all members of the court to do what they could within
receipts and outgoings accounting to bring about a result which was
something less than dramatically unfair, produced a variety of views. The
principle in Arthur Murray (1965) 114 C.L.R. 314 was not yet recognised
at the time of New Zealand Flax Investments Ltd and recognition of that
principle in the latter case was discouraged by an agreement between the
parties that may have prevented any application of the principle if it had
been recognised. In general the direction of the court was that the taxpayer
should account for receipts on a cash basis. Though Dixon J. thought at one
point in his judgment that amounts presently receivable in respect of the
sale of “bonds” should be brought in, his final conclusion favoured the
bringing in of receipts on a cash basis. In this he was supported by Rich
and McTiernan JJ. That same three judges considered that an accruals basis
should apply in regard to outgoings for “interest” and deferred
commissions. This basis was more generous to the taxpayer than would be
thought consistent with the later decisions in James Flood Pty Ltd (1953)
88 C.L.R. 492 and Nilsen Development Laboratories Pty Ltd (1981) 144
C.L.R. 616 considered in [11.76]–[11.83] below. It contemplated the
allowance of deductions for interest and deferred commissions which were
at the time only contingently payable. New Zealand Flax Investments
should not be taken to support a view that a taxpayer on a cash basis in
regard to derivation of receipts may adopt an accruals basis in regard to the
incurring of an outgoing. The case is special in the respect that there was
limited room for development of the law open to the court because of the
agreement between the parties, and should not be taken as authority for any
principle of tax accounting.

11.55 Accruals accounting for a receipt can only be applicable in advance
of actual receipt where the taxpayer asserts a claim of right to a receipt. A
taxpayer who provides services may be on an accruals basis in regard to
rewards for services. If services are performed and the taxpayer asserts a
claim of right to a reward there will be an immediate derivation. If a
reward is in fact received that may have been anticipated but was not the
subject of an assertion of right by the taxpayer, there will be a derivation
on actual receipt. In Squatting Investment Co. Ltd (1954) 88 C.L.R. 413 the
taxpayer, presumably, derived a receipt in the distribution of the surplus of
proceeds of wool submitted for appraisal, when he actually received,
though there could be an argument made that he derived a receipt when the
legislation had been passed which gave him a right to the receipt. Where
there is a derivation of an amount on the assertion of a claim of right to a
receipt, there will not be a further derivation on actual receipt of that amount. The actual receipt is not an occasion of a derivation. It produces no tax consequences save that it will preclude a bad debt write-off under s. 63 or a loss deduction under s. 51(1).

11.56 It was seen in [5.37]–[5.48] above that a principle requiring contemporaneity may deny the deduction of an outgoing that is incurred after the cessation of a business. It has been assumed that there is no similar principle that would deny the income character of a receipt that is derived after a business has ceased. A question as to the existence of such a principle is unlikely to arise when the taxpayer is on an accruals basis. An amount is most likely to become receivable before cessation of the business. But it may not. And the receipt may not have been the subject of any claim of right so that it will be derived only when actually received. The possible application of a contemporaneity principle cannot be entirely excluded. In setting the scope of any such principle it will be necessary to have regard to A.G.C. (Advances) Ltd (1975) 132 C.L.R. 175, and the view expressed in that case that the incurring of a loss that is a direct outcome of an operation of the business during the time it was carried on is not subject to denial under the contemporaneity principle. It may follow that a receipt which is a direct outcome of a business operation, such as the supply of goods, is income notwithstanding that the business has ceased to be carried on. If the taxpayer in Squatting Investment Co. Ltd had ceased to carry on business at the time of the derivation of the benefit in respect of wool submitted for appraisal some years before, the receipt would none the less have been an income receipt.

**Derivation by an accruals basis taxpayer where the receipt is an item other than cash**

11.57 Section 21 of the Assessment Act provides that “where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for purposes of [the] Act, be deemed to have been paid or given”. The section may suggest that an item other than cash must always be accounted for on a basis equivalent to the cash basis, so that there is no derivation of income until actual receipt. The alternative is to apply an adapted accruals basis where the item is not a right to a sum of money but the taxpayer would account on an accruals basis if the item were a right to a sum of money. A land developer sells land that is trading stock to a company for cash, and for shares to be issued by the company. An adapted accruals basis would treat the arising of the right to the shares as a derivation. The amount of income derived might be
the present value of equivalent shares in the company at the time the right arises, discounted so as to take account of the effect of the prospective issue on the present value of shares in the company. It would not be appropriate to treat the item derived as the present value of the right to the share issue. If the right to the share issue is a right not to a present issue but an issue in the future, there will be questions of the accruals accounting applicable to a right to cash receivable in the future, and the manner in which that accounting might be adapted to a right to a receipt other than cash.

11.58 A view that derivation must wait on actual receipt of an item other than cash is the more convenient, save where the event that gave rise to the right to a receipt other than cash was the realisation of trading stock. Delaying derivation until actual receipt in that case involves the prospect that the trading stock—possibly shares of a share trader that have been disposed of in response to a share exchange take-over bid—will have ceased to be on hand so that there is a failure to match receipts and outgoings.

11.59 There is a question as to what is an actual receipt where the item receivable is itself a chose in action. In Abbott v. Philbin [1961] A.C. 352 and Donaldson (1974) 74 A.T.C. 4192, in both of which the taxpayer was, presumably, on a cash basis in relation to the item, there was held to be a derivation when options over shares were issued to him. One must distinguish the arising of a right to the issue of options, which would not be a derivation, and the arising of the rights given by the options when they are issued, which would be a derivation.

11.60 Abbott v. Philbin and Donaldson are authority that there is an actual receipt of a chose in action, notwithstanding that the chose in action is defeasible (Abbott v. Philbin) or contingent (Donaldson). There is thus a distinction between derivation where an accruals basis taxpayer comes to have a right to receive—contingency, at least, will prevent derivation—and derivation by actual receipt of a chose in action.

11.61 Insisting that there is no derivation of an item other than cash until the item is actually received would answer the reasoning of Lord Denning in Abbott v. Philbin, who saw the majority decision as involving the conclusion that a taxpayer who becomes entitled to some benefit which he may not choose to take must be taxed on the right to the benefit. The conclusion would extend to a taxpayer on a cash basis in relation to that item and to a taxpayer on an accruals basis. A taxpayer in circumstances such as those in Cooke and Sherden (1980) 80 A.T.C. 4140 may be entitled, because of the quantity of purchases he has made from his supplier, to an expense paid holiday. There would be no suggestion,
whether he be regarded as on an accruals or a cash basis in regard to his trading receipts, that he has derived an item of income if he has chosen not to take up his entitlement.

The operation of section 19

11.62 Where an amount is receivable, there may be a derivation by a cash basis taxpayer on some event which is not an actual receipt of the cash receivable. The event may be one covered by s. 19 of the Assessment Act, which deals expressly with a number of circumstances which will give rise to a derivation, though there has not been an actual receipt and the taxpayer is on a cash basis in regard to the item. Section 19, it will be suggested, is a partial expression of a principle, which might be called a constructive receipt principle, which gives meaning to the word “derived” in s. 25(1).

11.63 Where an amount is receivable, but there is as yet no derivation by an accruals basis taxpayer—the amount may not yet be ascertained or ascertainable, or it may not be presently receivable and present receivability is held in the circumstances to be essential to a derivation—s. 19 may, in some events, bring about a constructive derivation. And again there may be a constructive derivation within the meaning of the word “derived” in s. 25(1), a meaning wider than s. 19. It is true that s. 19 in its terms—“not actually paid over to him”—may appear to be concerned only with derivation where the item is to be accounted for on a cash basis, but it is none the less capable of application in relation to an item accounted for on an accruals basis, and a wider principle of constructive receipt may extend to items accounted for on an accruals basis.

11.64 A taxpayer, or another person acting on his behalf, may deal with a receivable so that it is “reinvested, accumulated, capitalised, carried to any reserve, sinking fund or insurance fund however designated”. The language is that of s. 19. The section has been held, in Brent (1971) 125 C.L.R. 418 (where the issue was receipt of an item to be accounted for on a cash basis), not to be attracted where the taxpayer simply does not seek to obtain payment of the amount of a receivable, and there is a dictum of Gibbs J. in the case that s. 19 would not have been attracted had the taxpayer expressly asked the debtor not to pay him. Permanent Trustee Co. (Executor of Estate of F. H. Prior, dec'd) (1940) 6 A.T.D. 5 is authority that s. 19 is not attracted where a taxpayer who has no prospect of obtaining payment of interest receivable agrees to a proposal that the interest be capitalised. The case may be thought to gloss the section so as to limit its scope. In any case, these authorities have no bearing on the operation of s. 19 in relation to an item to be accounted for on an accruals
basis. In all of them there would already have been a derivation if accruals had applied. *Gair* (1944) 71 C.L.R. 388 is concerned with the operation of s. 19 in relation to derivation on a cash basis in circumstances where there may not as yet have been a derivation on an accruals basis. At least in the view of Latham C.J., the assignment of a receivable involves a receipt, though the item is to be accounted for on a cash basis. It might be said that, a fortiori, it is a receipt where the item is to be accounted for on an accruals basis. Assuming that an amount that is not presently receivable is for this reason to be regarded as not yet derived, the assignment of it should give rise to a derivation. There is a question in these circumstances of the amount so derived. The view is taken in [13.22] below, in dealing with assignment of income, that the amount derived is the amount realised in a commercial transaction of which the assignment is part. If the assignment is wholly or partly by way of gift, the amount derived is the value of the receivable at the time of the assignment. In the result, there will be an equivalence with the accounting applicable where there is a derivation of the amount receivable at the time the receivable arises, and thereafter there is an assignment of the receivable in circumstances that give rise to a loss deduction under s. 51(1).

**11.65** If s. 19 is not sufficient to support these conclusions they may be supported by general law yet to be developed from the interpretation of the word “derived” in s. 25.

**The operation of section 101A**

**11.66** *C. of T. (N.S.W.) v. Lawford* (1937) 56 C.L.R. 774 expresses a logical implication of the cash method of accounting. At the time of his death a substantial sum was owing to a professional man in respect of fees. It was held that when these fees were paid to his estate there was no income of the deceased upon which the estate was liable to tax. Nor was there income of the estate: the fees were received by the estate as capital. The principle in *Lawford* would apply not only to salary for work done to the date of death, but also to interest or rent in respect of the use of money or property to the date of death.

**11.67** The effect of *Lawford*, so far as it concluded that the fees when received were not income of the estate, has been reversed by s. 101A of the Assessment Act and the application of the section has been clarified to some extent by the High Court in *Single* (1964) 110 C.L.R. 177. The majority held that s. 101A could apply to a receipt which was not receivable and not ascertained at the time of death. Section 101A may thus have some application to an accruals basis taxpayer.
11.68 *Single* may support a view that an amount received by a trustee after death which is for services performed prior to death, or for the use of money or property up to the time of death, will be income of the trust estate where the deceased was on an accruals basis in regard to the item, but there had not been a derivation by the deceased up to the time of his death. The amount may not have been ascertained at the time of death, or its receivability may have depended on other services being performed, or the lapse of further periods of time. There may be thought to be some difficulty in reading the words of s. 101A—“if it had been received by him during his lifetime”—as extending to the arising of a receivable that would have been a derivation by a taxpayer on an accruals basis of return in relation to the item. But s. 101A was in effect read in such a way in *Single*. An actual receipt by the deceased of a share of the proceeds of work done prior to his death would not have been significant. A derivation by him during his lifetime would have depended on a partnership account having been taken, and the arising in him of an individual interest in the net income of the partnership as determined by s. 90.

11.69 Kitto J. in *Single* would have limited the operation of s. 101A so that it is hard to see how it could have any application to a deceased who was on an accruals basis of return in relation to the item. Kitto J. would have confined its operation to circumstances where an amount was presently receivable by the deceased at the time of his death. Menzies and Owen JJ. refused to limit the operation of the section in this way. Owen J. said: “There is, in my opinion, no justification for treating the section as requiring the introduction of a further assumption that the amount which the deceased is to be regarded as having received during his life was an amount which was then due and payable” ((1964) 110 C.L.R. 177 at 191).

11.70 It may express the effect of *Single* to say that there is a derivation of income under s. 101A by the estate of a deceased person where there is a receipt of an amount that reflects a return for work performed by or on behalf of the deceased, or reflects a return for the use of money lent or property let by the deceased, or which is a dividend on shares which were owned by the deceased for some period prior to his death. The amount of income derived by force of s. 101A will be limited to that part of the receipt that reflects the return for work performed by the deceased, for the period of the loan or letting prior to death, or the period to which the dividend relates that elapsed during the lifetime of the deceased. This part of the receipt will be income of the deceased estate notwithstanding that a derivation of the amount by the deceased would have depended on the amount becoming due to him and not on its actual receipt by him. If the amount of the receipt by the estate reflects in part work done by the trustee
after the death of the deceased, or is in respect of a period of time after the
death of the deceased, the receipt may to this extent be income of the
deceased estate by the operation of s. 95.

11.71 The absence of a provision such as s. 101A in the South Australian
Taxation Act is the explanation of the Commissioner's action in Carden's
case (1938) 63 C.L.R. 108 in asserting that an accruals basis was
appropriate for the broken period to the date of death and for the 1934 and
1935 years of income. An accruals basis for these years would,
preumably, have enabled him to bring in those items, as accruals, though
they had not been received at the date of death. But the effect of
substituting accruals for any of the broken period, the 1934 or the 1935
year, would be to allow items to escape tax which had accrued in the last
year assessed on a cash basis. It would only have been possible to ensure
that all items were brought to tax if the taxpayer could have been required
to account on an accruals basis for every year he had carried on the
professional practice. The Commissioner's powers of amendment did not
go so far. A change from cash to accruals will always involve some items
escaping inclusion in assessable income, and some items being denied
deduction. In Henderson (1970) 119 C.L.R. 612, it was the taxpayer who
sought the change in accounting basis. Windeyer J. attempted to prevent
the escape by insisting that in the first year of accruals accounting the
accruals of the last year of cash accounting were also to be brought to
account. This, he considered, was necessary to ensure that the basis of
accounting in the year of change truly reflected the income of that year.
The Full Court, however, rejected this attempt to prevent the escape,
insisting that there is no warrant “for combining the results of more than
one year in order to obtain the assessable income for a particular year of
tax” (per Barwick C.J. at 649).

11.72 Where there is a change from cash to accruals, as in Henderson, s.
101A does not prevent the escape. The accruals of the last year of return on
a cash basis will very likely have matured into actual receipts before death
and are not for this reason affected by s. 101A. If any of these accruals do
become receipts after death they will not be amounts which would have
been assessable income if received by the deceased during his lifetime
because at most times of all possible times of receipt the taxpayer was on
an accruals basis. If s. 101A is to achieve anything in preventing the
escape, it must be read as “which would have been assessable income if
received by the deceased, in the year of income in which it became
receivable”.

The Meaning of Incurring of an Outgoing on an Accruals
Basis of Tax Accounting

11.73 One would expect that principles in regard to the moment of incurring of an outgoing would be symmetrical with principles examined under the last heading in regard to derivation of a receipt. Such a symmetry, in general, obtains. Where a principle is unsettled it is possible to argue, in terms of the need for symmetry, for a principle which reflects a settled principle in regard to the derivation of a receipt. A settled principle in regard to the incurring of an outgoing may serve to supply a principle in regard to the derivation of a receipt. The law that follows in respect to the incurring of an outgoing may serve to resolve questions as to the meaning of derivation raised in earlier paragraphs. Thus it would appear to be settled by Commonwealth Aluminium Corp. Ltd (1977) 77 A.T.C. 4151 and Commercial Union Assurance Co. Ltd (1977) 77 A.T.C. 4186 than an outgoing may be incurred though there is no legal liability to pay. In Commercial Union it was enough that the taxpayer acknowledged liability to indemnify the insured, even though a failure by the insured to notify the taxpayer within time precluded any legal liability. Commercial Union in this way would supply a principle argued for in [11.52] above that a receipt is derived if there is a claim of right to that receipt, whether or not the receipt is legally recoverable. The dictum in regard to a requirement of legal recoverability in the judgment of Barwick C.J. in Henderson, referred to in [11.46] above, presents some difficulty, but it should not stand in the way. There is a necessary corollary of the principle adopted in Commercial Union: a withdrawal of an acknowledgement of liability that was an outgoing incurred is a derivation of income. A like corollary would apply in regard to a derivation of a receipt: the abandonment of a claim of right that is a derivation of income is the incurring of an outgoing. The ultimate discharge of a liability for less than the amount at which it stands acknowledged will generate an item of income, following principles examined in [12.181]–[12.191] above. If the discharge involves payment of a greater amount, there will be a loss that is deductible.

11.74 Commonwealth Aluminium supports the view that incurring of an outgoing may arise from the acknowledgement of a liability. The acknowledgement concerned a liability that was defeasible in the event of the taxpayer's success in an appeal to the Privy Council challenging the validity of the legislation under which the liability arose. This element of defeasibility, in the view of Newton J., did not prevent the incurring of an outgoing. The taxpayer acknowledged that subject to such defeasance he was liable to pay an amount determined under the legislation. Newton J. relied on James Flood Pty Ltd (1953) 88 C.L.R. 492 considered in this
aspect in [11.78] below, for a view that the defeasibility of a liability does not preclude the incurring of an outgoing. If the defeasance occurred, the taxpayer's acknowledgement would, presumably, be withdrawn, and there would at that time be a derivation of income equivalent to the outgoing incurred. Newton J. was conscious of the difficulty posed by the High Court decision in *H. R. Sinclair & Son Pty Ltd* (1966) 114 C.L.R. 537 considered in [2.547]–[2.552] above, and the subject of further consideration in [11.243] below.

**11.75** The law on incurring of an outgoing on an accruals basis adopts principles in regard to the relevance of a present liability to pay, the contingent nature of a liability, the defeasibility of a liability and the ascertainability of the amount of a liability that parallel equivalent principles in regard to derivation of a receipt.

**11.76** There is a dictum in *James Flood Pty Ltd* (1953) 88 C.L.R. 492 at 507 that a “debitum in praesenti solvendum in futuro” may be an outgoing incurred. The principle is applied in *Alliance Holdings Ltd* (1981) 81 A.T.C. 4637 and *Australian Guarantee Corp. Ltd* (1984) 84 A.T.C. 4642 so as to allow a deduction of interest in respect of the past use of money though the interest is not payable until the money borrowed is repaid. It is true that the dictum in *James Flood* seems inconsistent with an observation made by the court in *W. Nevill & Co. Ltd* (1937) 56 C.L.R. 290 at 302-3 per Latham C.J. and at 307 per Dixon J. The court in *James Flood* (at 507) explained the observation in *Nevill* by saying: “nothing that was decided in *Nevill* . . . was intended to imply that a liability to pay an ascertained sum is never incurred until the sum becomes due and payable.” The dictum in *James Flood* was approached with some caution by Barwick C.J. in *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616 at 624 where he said: “It may not disqualify the liability as a deduction that, though due, it may be paid in a later year.” It will be recalled that Barwick C.J. showed a similar cautious approach in *Henderson* (1970) 119 C.L.R. 612 to a principle that there may be a derivation of income though an amount is not presently receivable ([11.46] above). The caution could only have been intended to relate to items other than receivables for trading stock supplied. *J. Rowe & Son Pty Ltd* (1971) 124 C.L.R. 421 is clear authority that in regard to the latter there can be a derivation of income notwithstanding that the amount is not presently receivable. If an outgoing is treated as incurred on the arising of a liability to pay in the future, the amount of the outgoing will, presumably, be the amount payable in the future. It will be the amount payable notwithstanding that there is no obligation on the taxpayer to pay interest on the debt. A principle which would assert that the present value of the liability is the amount of the deduction may be seen as rejected by
Rowe in its decision in regard to derivation of an income item.

11.77 *James Flood Pty Ltd* (1953) 88 C.L.R. 492 is authority that a liability that will arise only on the happening of a contingent event is not before that event an outgoing incurred. A liability on a taxpayer to pay interest owed by another, contingent on a demand by the lender, is not yet an outgoing incurred (*Marbren Pty Ltd* (1984) 84 A.T.C. 4783). *James Flood* involved liabilities to pay employees while on holiday, liabilities that were contingent on periods of service that could be completed only in the following year of income. The case might equally have been decided on the ground that the amounts of the liabilities were not yet ascertained or ascertainable, which is a way of expressing the ground of decision in the later case of *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616. But *James Flood* offers authority for a principle as to the relevance of an element of contingency, equivalent to the principle considered in [11.49] above in relation to the derivation of an income item.

11.78 There is an observation in *James Flood* which will support a view that the defeasible character of a liability will not prevent it being an outgoing incurred by an accruals basis taxpayer. The court said:

"[The] words ['losses and outgoings incurred'] perhaps are but little more precise than the word ‘established’ or the expression . . . ‘definitively committed’. But they do not admit of the deduction of charges unless, in the course of gaining or producing the assessable income or carrying on the business, the taxpayer has completely subjected himself to them. It may be going too far to say that he must have come under an immediate obligation enforceable at law whether payable presently or at a future time. It is probably going too far to say that the obligation must be indefeasible" ((1953) 88 C.L.R. 492 at 506).

If a defeasible liability is treated as an outgoing incurred there must be a derivation of income equivalent to the amount allowed as a deduction if the defeasance occurs and the liability ceases. The view is taken above that an acknowledgement of a liability may be an outgoing incurred, and that a subsequent acknowledgement that the liability has ceased will involve a derivation of income. That view expresses a principle that is to be preferred to a principle that is cast in terms of the arising of a legal liability and cessation of liability. But a principle cast in terms of legal liability stands in equal need of a recognition that cessation of liability may be a derivation of income.

11.79 In *James Flood* the taxpayer's liabilities in regard to holiday pay were contingent. In *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616 the liabilities in regard to long service leave pay were no longer contingent. Qualifying periods of service had been completed. But there was a factor common to *James Flood* and *Nilsen* that will explain the
decision in *Nilsen*, and could also have been relied on to support the denial that an outgoing had been incurred in *James Flood*. The amount of the liability was neither ascertained nor ascertainable, since it was dependent on the rate of pay of the employee at the time he took leave, or resigned from his employment and became entitled to an amount equivalent to what he would have received if he had remained in service and taken his holiday. In judgments of the Federal Court and of the High Court in *Nilsen* the denial of a deduction is put on the ground that the taxpayer had not come to be under a “pecuniary liability”. The liability was to allow a paid holiday, and not to pay the employee while on holiday. This ground, it is now suggested, is no more than an assertion that there is no outgoing incurred until the amount of it is ascertained or ascertainable. Financial accounting may treat as an expense an estimate of the amount of a liability reflected in a provision made in accounts. But tax accounting, when the accounting is for receipt and outgoings, does not admit of an estimate of that kind. The estimate contemplates a procedure for correcting the amount of the estimate, by compensating items in subsequent years, or by reopening of assessments, to ensure that the amount of the liability ultimately ascertained is the amount for which deduction is allowed. There is a procedure for corrections of this kind in s. 170(9) which will ensure that the correct amount of profit or loss is brought in or allowed where specific profit accounting is appropriate. But no such procedures are available where receipts and outgoings accounting is applicable.

**11.80 Nilsen**, as a decision on the incurring of outgoings in respect of long service leave, holiday leave and other leave of employees, has been deprived of significance by the enactment of s. 51(3) which establishes a specific rule of tax accounting that a deduction is not allowable in respect of “long service leave, annual leave, sick leave or other leave except in respect of an amount paid to the person to whom the leave relates or, where that person is deceased, to a dependant or personal representative of that person and, for the purposes of [subs. (1)], the amount paid shall be deemed to be a loss or outgoing incurred at the time when the payment is made”. The case remains significant as a decision on general principles of tax accounting. As a decision which would distinguish a liability to provide paid leave from a liability to pay on the occurrence of an event that must occur, the case is not helpful. The distinction, with respect, is verbal only. As a decision that an outgoing is not incurred until the amount of a liability is ascertained or becomes ascertainable the case leaves unresolved a question of the continuing significance of three decisions of the Victorian Supreme Court in *R.A.C.V. Insurance Pty Ltd* (1974) 74 A.T.C. 4169, *Commonwealth Aluminium Corp. Ltd* (1977) 77 A.T.C. 4151 and
11.81 Commonwealth Aluminium supports a principle that there may be an outgoing incurred if some estimate can be made of the amount of an acknowledged liability, even though the amount is not even theoretically ascertainable because the formula by which it will be ascertained has not yet been established so that the estimate is only a prediction. If symmetry is to be preserved between the law as to derivation of a receipt and the law as to incurring of an outgoing, the decisions in Australian Gas Light Co. referred to in [11.51] above, and in Commonwealth Aluminium cannot both stand as good law. R.A.C.V. Insurance and Commercial Union can be explained on the basis that the amounts of the acknowledged liabilities were theoretically ascertainable. The law of damages assumes that there is a sum which is the correct amount of a liability to compensate another for damage to his property or for personal injury, so that the amount of the liability of an insurance company to indemnify an insured person in respect of events that have occurred before the end of a year of income is theoretically ascertainable, even though the insurer at year end does not know that those events have occurred.

11.82 The distinction thus drawn between R.A.C.V. Insurance and Commercial Union on the one hand and Commonwealth Aluminium on the other, is perhaps too fine to be useful and all three cases might be taken as supporting a principle that an estimate of the amount of a liability that does not purport to be any more than a prediction may be an outgoing incurred. A consequence is recognised in all three cases that as the estimate proves to be wrong, or, indeed, is displaced by a new estimate in a later year of income, there will be an incurring of a further outgoing if the actual liability proves to be more or the estimate increases, or a derivation of income if the actual liability proves to be less or the estimate decreases. Flexibility of this order may be beyond the capacity of the income tax law, though, it must be conceded, the law argued for in this Volume in regard to derivation by claim of right and incurring of an outgoing by acknowledgement of liability requires a substantial measure of flexibility.

11.83 Mason J. was the only judge in Nilsen Development Laboratories (1981) 144 C.L.R. 616 to refer to R.A.C.V. Insurance, Commercial Union and Commonwealth Aluminium. He did not reject them, presumably because they were concerned with pecuniary liabilities while Nilsen was not. He said (at 632):

“I agree with the Chief Justice's comment on the observations of Dixon J. in New Zealand Flax Investments . . . (1938) 61 C.L.R. 179 at 207. And I do not understand R.A.C.V. Insurance . . . to have decided otherwise. There, Menhennitt J. held that the taxpayer, an insurance company, was entitled to deduct as a loss outgoing under s.
an amount reasonably estimated to be the total amount which it would have to pay in respect of its liability to indemnify insured drivers against third parties incurred, but not reported, during the year of income. The estimate was made in respect of accidents occurring in that year which gave rise to liability under policies then in existence. Commercial Union Assurance . . . falls into the same category. See also Commonwealth Aluminium . . . where the taxpayer completely subjected itself to liability to pay royalties” (Emphasis in original).

The Chief Justice's comment referred to by Mason J. was the following (at 623):

“In my opinion the language of Dixon J. in New Zealand Flax Investments . . . (1938) 61 C.L.R. 179 at 207 needs to be carefully perused and applied. Granted that exhaustive definition of what may be denoted by the word ‘incurred’ in s. 51(1) may not be possible, there can be no warrant for treating a liability which has not ‘come home’ in the year of income, in the sense of a pecuniary obligation which has become due, as having been incurred in that year.”

11.84 The implied approval by Mason J. of R.A.C.V. Insurance, Commercial Union and Commonwealth Aluminium is reinforced by the final words of the passage quoted from his judgment that the taxpayer in Commonwealth Aluminium “had completely subjected itself to liability to pay royalties”.

11.85 R.A.C.V. Insurance, Commercial Union and Commonwealth Aluminium make a substantial contribution to the scope within receipts and outgoings accounting for matching of receipts and outgoings. In all three cases attention is drawn to the need to recognise expenses of the estimated amounts of liabilities in order to ensure that the profit shown in the financial accounts of a taxpayer are not distorted. There is an assumption that it is equally important to recognise outgoings of estimated amounts of liabilities in order that taxable income should not be distorted.

11.86 Commercial Union (1977) 77 A.T.C. 4186 and R.A.C.V. Insurance (1974) 74 A.T.C. 4169 may be thought to cast doubt on the earlier decision in Herald & Weekly Times Ltd (1932) 48 C.L.R. 113, so far as that case may be taken to have decided that a liability in defamation is an outgoing incurred when the amount of the liability is ascertained by verdict in an action. The issue of time of derivation was not in fact raised in the case. There is this difference however between Herald & Weekly Times and the later cases: the taxpayer in Herald & Weekly Times did not acknowledge any liability until that liability was finally determined by action. The view has been taken above that the moment of acknowledgement of liability is the moment of incurring an outgoing by an accruals basis taxpayer, not when a legal liability arises—a legal liability that may not be confirmed until a court decision is given.

11.87 The most significant development in tax accounting in the cause of
matching receipts and outgoings is the decision in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314 more closely considered in [11.89]ff. below. The method of the *Arthur Murray* decision is to defer the recognition of a receipt as an item of income derived until the item is earned, in the sense that the taxpayer has performed the acts which are the consideration for the receipt. The receipt is treated as derived as performance proceeds, and in proportion to that performance. Performance and the incurring of outgoings will generally run together. To the extent, however, that outgoings are treated as incurred in advance of performance, the achievement of *Arthur Murray* in matching receipts and outgoings is frustrated. A too enthusiastic application of a principle that will treat the estimated amount of a liability as deductible though the liability relates to a future supply of goods or services, will involve such frustration. It is true that frustration is in any case involved if outgoings that are not yet fully consumed are treated as outgoings incurred. But the advancing of the time of incurring that may result from treating estimated amounts of liability as incurred will increase the possible frustration. *Arthur Murray* is no more than a partial recognition of a matching principle. A more thoroughgoing recognition would seek to relate derivation of a receipt to the incurring of related expenses, rather than to performance of the acts that are the consideration for the receipt. This would to a degree overcome the distortion that results from the principle in *Nilsen*, and s. 51(3). The more thoroughgoing principle would require reconsideration of the *Arthur Murray* principle. A more realistic prospect is the recognition of a principle argued for in this Volume, that an outgoing is not incurred until it is consumed. There is no decision directly in the way of such a recognition, and the principle has the support of the Federal Court in *Australian Guarantee Corp. Ltd* (1984) 84 A.T.C. 4642. A combination of *Arthur Murray* and such a principle would go a considerable distance towards an acceptable matching, though distortion would continue where income does not arise until after matching outgoings are fully consumed, or outgoings do not arise until matching income has been fully earned. Matching in these circumstances requires the advancing of the arising of income or the advancing of the arising of outgoings, which is probably beyond the capacity to be flexible of any system of tax accounting.

**11.88** On the view taken in this Volume a taxpayer on an accruals basis in relation to an item, who acknowledges a liability to pay may incur an outgoing, notwithstanding that he doubts that he is legally liable to pay, and will pay under protest anticipating that he might in due course recover what he has paid after successfully challenging the validity of the law under which it is said his liability arises. *Commonwealth Aluminium* was a
case of this kind. The time of incurring of the outgoing is the time of acknowledgment. Payment in fact will support the acknowledgement but the payment is not the incurring of an outgoing. Where there has been no acknowledgement of a liability to pay, the incurring of an outgoing must wait on actual payment. The common situation will be a voluntary payment by the taxpayer. The concept of actual payment will, presumably, be the same as actual payment where the taxpayer is on a cash basis in relation to the item.

**Tax Accounting for Receipts “in Advance” and for Outgoings “in Advance” Under Accruals Accounting**

11.89 Reference has already been made ([11.87] above) to the role of the principle in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314 in promoting a matching of receipts and outgoings. The possible achievement of the principle is limited. The spreading forward of a receipt so that it is derived over a number of years of income is appropriate only so long as the receipt retains the inherent characteristic that it, or its equivalent, may have to be returned, in whole or in some part, to the person from whom it was received. Such spreading will in many cases have the effect that derivation occurs over the years in which there are matching outgoings. But the method of spreading is not designed to achieve this result. The expenses of the performance of services which are the quid pro quo for a receipt will very likely be outgoings incurred in the years of performance—years in which there will continue to be the prospect for the taxpayer that he may have to return, perhaps by way of damages for failure to perform, some part of the amount of the receipt. But some expenses of performance may not be incurred until after performance is complete, for example the expense of a payment to an employee taking holidays or long service leave, or a payment in lieu of such made to an employee who retires, or to the estate of an employee who has died.

11.90 *Arthur Murray* does not allow the anticipation of a derivation of income so that there might be income derived in years in which related outgoings have been incurred.

11.91 The case involved receipts. It may suggest a parallel principle in regard to outgoings, but the case does not decide that there is a parallel principle which would direct that an outgoing is incurred only as it is consumed—the whole of it is not incurred until there is no remaining benefit from the outgoing that may affect income derivation. A parallel principle would in any case be confined to outgoings that are in other respects incurred: it would not allow the anticipation of an outgoing. *Nilsen*
Development Laboratories and s. 51(3) do not conflict with a principle in regard to outgoings parallel with that in *Arthur Murray*.

11.92 *Arthur Murray* and any parallel principle in regard to outgoings work with receipts and outgoings tax accounting. Specific profit tax accounting may allow greater flexibility in matching costs and proceeds, but, it will be seen, there are limits also on its possible achievement.

11.93 The judgment in the High Court in *Arthur Murray* makes some reference to the background of practice by the Commissioner prior to the decision:

> “. . . we are told that the Department was accustomed to take the view we have expressed until an opinion grew up that to do so was in some way inconsistent with the judgment of this court in the case of Federal Commissioner of Taxation v. James Flood Pty Ltd (1953) 88 C.L.R. 492” ((1965) 114 C.L.R. 314 at 320).

The Commissioner might be pardoned for thinking that the denial of the deductibility of the provision for leave yet to be taken in *James Flood* required the denial of the deductibility of a provision for income yet to be earned. The effect of the *Arthur Murray* decision in financial accounting terms is to allow deduction of the latter provision. But in tax accounting the two provisions are distinguishable. A provision for leave yet to be taken seeks to anticipate the incurring of an outgoing. A provision for unearned income seeks to defer income that is otherwise derived. Which is not to say that a provision for unearned income may not bring about the same result in some circumstances as a provision for an expense yet to be incurred. It will have the same effect where the expense when incurred will be incurred in the performance of the acts which are the quid pro quo for the receipt.

11.94 The Commissioner's practice prior to *James Flood Pty Ltd* (1953) 88 C.L.R. 492 apparently recognised that an actual receipt in respect of the supply of goods or the provision of services was not income derived until the tender of delivery of the goods or the performance of the services. The *Arthur Murray* principle aside, it may be assumed that an actual receipt in these circumstances is a derivation of income. It is a derivation, notwithstanding that there would as yet be no derivation by an accruals basis taxpayer of an amount receivable in the same circumstances, unless all contingency in regard to the receivable has been removed by an agreement that the amount was receivable irrespective of delivery or performance of the services. One may assume that the Commissioner's practice in regard to an actual receipt would have extended to an item receivable by an accruals basis taxpayer irrespective of delivery or performance. The Commissioner's practice would appear however to have been different at the time of *New Zealand Flax Investments* (1938) 61 C.L.R. 179. There is no indication in that case that the Commissioner was prepared to treat the derivation of the bond receipts as deferred until the performance of the work that the taxpayer had undertaken to perform as
the quid pro quo for the receipts.

11.95 There are some observations by members of the court in *New Zealand Flax Investments* (1938) 61 C.L.R. 179 that could perhaps be seen as searching for an *Arthur Murray* principle, but the search was readily abandoned. Starke J. (at 197) related that during argument “the court inquired whether the sum . . . received from the sale of bonds was income . . . The only answer the court received was that the Act taxes the gross income of the taxpayer—all that comes in—subject to certain statutory deductions . . .”. He then observed: “The . . . answer overlooks the fact that the [Act] imposes a tax upon income. It is not a tax upon everything that comes in whether an income receipt or a capital receipt.” The concluding words in the passage quoted may indicate that Starke J. had in mind the possibility, not of an *Arthur Murray* principle, going to the time of derivation, but a principle identified in [2.113]ff. above as the contribution to capital principle. The latter principle would justify a conclusion that the bond receipts were not income to the extent that New Zealand Flax Investments was required to use them in the purchase of land the title to which would be vested in the bondholder. Views expressed by Dixon J. in regard to the operation of receipts and outgoings tax accounting describe a system (at 199): “. . . under the *Income Tax Assessment Act* 1922–1930, [by which] the assessment must begin by taking, under the name of assessable income, the full receipts on revenue account, and only such deductions must be made as the statute in terms allows.” This approach suggests a rigidity that would have no place for an *Arthur Murray* principle. It is true that Dixon J. sought some flexibility in regard to outgoings, and did allow deductions that would now be denied under *James Flood*. But he saw the scope for anticipating outgoing as a means of achieving some matching with receipts that had to be treated as income derived, as very limited.

11.96 The specific effect of the *Arthur Murray* decision is that a receipt which would otherwise be income derived by the taxpayer, depending on his appropriate basis of accounting, will not be income until the services to which it relates have been performed or it becomes apparent that the taxpayer will not be called on to perform those services. The statements of principle in *Arthur Murray* are not, however, in terms confined to services-to-be-performed situations. The joint judgment of Barwick C.J., Kitto and Taylor JJ. supports a general principle that income will be derived only if gains have “come home” beneficially to the taxpayer in circumstances in which “they may properly be counted as gains completely made, so that there is neither legal nor business unsoundness in regarding them without qualification as income derived” ((1965) 114 C.L.R. 314 at 318). The
judgment asserts that:

“The ultimate inquiry . . . must be whether that which has taken place . . . is enough by itself to satisfy the general understanding among practical business people of what constitutes a derivation of income. A conclusion as to what that understanding is may be assisted by considering standard accountancy methods, for they have been evolved in the business community for the very purpose of reflecting received opinions as to the sound view to take of particular kinds of items. This was fully recognised and explained in Carden's case, especially in the judgment of Dixon J.; but it should be remarked that the court did not there do what we were invited to do in the course of the argument in the present case, namely to treat the issue as involving nothing more than an ascertainment of established bookkeeping methods. A judicial decision as to whether an amount received but not yet earned or an amount earned but not yet received is income must depend basically upon the judicial understanding of the meaning which the word conveys to those whose concern it is to observe the distinctions it implies. What ultimately matters is the concept; bookkeeping methods are but evidence of the concept.”

11.97 Neither the words of the Assessment Act nor any judicial decision stood in the way of the relevant general understanding among practical business people. James Flood Pty Ltd (1953) 88 C.L.R. 492 was to be regarded as a decision on the meaning of the word “incurred” in s. 51(1), and thus had no application. It should be noted that the matter was before the High Court on a case stated in which, by agreement, business and accounting principles relevant to the facts were set out as being established principles. It may be asked whether it would now be open to the Commissioner to assert a general understanding among practical business people different from that reflected in the agreed principles in the case stated.

11.98 The court's perception of the “general understanding among practical business people of what constitutes a derivation of income”, relevant to the facts of Arthur Murray, is explained in the following passage:

“It is true that in a case like the present the circumstances of the receipt do not prevent the amount received from becoming immediately the beneficial property of the company; for the fact that it has been paid in advance is not enough to affect it with any trust or charge, or to place any legal impediment in the way of the recipient's dealing with it as he will. But those circumstances nevertheless make it surely necessary, as a matter of business good sense, that the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed quid pro quo not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself. In our opinion it would be out of accord with the realities of the situation to hold, while the possibility remains, that the amount received has the quality of income derived by the company. For that
reason it is not surprising to find, as the parties in the present case agree is the fact, that according to established accountancy and commercial principles in the community the books of a business either selling goods or providing services are so kept with respect to amounts received in advance of the goods being sold or of the services being provided that the amounts are not entered to the credit of any revenue account until the sale takes place or the services are rendered: in the meantime they are credited to what is in effect a suspense account, and their transfer to an income account takes place only when the discharge of the obligations for which they are the prepayment justifies their being treated as having finally acquired the character of income” ((1965) 114 C.L.R. 314 at 319).

The scope of the decision in its effect on receipts and outgoings tax accounting, and in its application to the circumstances of the case and to other circumstances, requires examination.

11.99 Arthur Murray (1965) 114 C.L.R. 314 was concerned with fees for dancing lessons yet to be given. The fees had already been the subject of actual receipt by the taxpayer. Some statements in the judgment may suggest that the law established in the case is confined to actual receipt. There can be no basis in principle, where the item is accounted for on an accruals basis, for drawing a distinction that would exclude the application of the case to a receivable where that receivable is otherwise derived—the amount is ascertained or ascertainable, and there is no element of contingency affecting the taxpayer's right to receive. If a customer in the circumstances of the Arthur Murray case has agreed to pay for lessons and his agreement is not in its express or implied terms conditional on lessons having been given, there is a derivation by the person providing the lessons, which will be governed by the Arthur Murray principle.

11.100 If the taxpayer is on a cash basis in relation to the item of receipt, there can be no room for the law established in Arthur Murray until there has been an actual receipt.

11.101 In the view of the court the general understanding among practical business people would have deferred the derivation of the fees received until there had been performance of the obligations the taxpayer had undertaken. The judgment is not definitive on the question whether there must have been complete performance of the obligations to which the receipt relates before there is a derivation. It would be assumed, however, that derivation occurs as performance proceeds, which raises the question of how the stage of performance is to be measured. On the facts of Arthur Murray, a measure in terms of the number of lessons given of the total number promised to be given is suggested, a measure which would generally correspond in its effect with a measure that judges performance in terms of the expenses incurred as a fraction of the estimated total expenses that will be incurred in giving the lessons promised. In other
facts, for example an advance receipt for the maintenance of new machinery for a period, it may be expected that the obligation will become the more onerous as the period elapses, and a simple formula by which to assess the measure of performance is not readily found. If a time lapse formula is adopted, there will be a limited achievement in matching receipts and outgoings. Whatever formula is adopted, it will, presumably, be concerned with a measure of performance and not with a measure of expenses incurred. The point has already been made that *Arthur Murray* does not offer a method of overcoming the defeat of a matching of receipts and outgoings that is implicit in *Nilsen Development Laboratories Pty Ltd* (1981) 144 C.L.R. 616 and in s. 51 (3) of the Assessment Act.

11.102 In a statement subsequent to the decision in *Arthur Murray*, the Commissioner gave some indication of his views on the scope of the decision. In one paragraph of that statement the suggestion is that the decision has no application to a contract to perform services unless “a specific number of . . . services . . . are to be provided” or “services are to be rendered as required over a fixed period of time”. In these instances there is a ready measure of degree of performance, but there is no basis in the *Arthur Murray* decision for limiting the decision to circumstances in which a ready measure is available. In fact a broader view seems to be contemplated in another paragraph of the Commissioner's statement where it is said:

> “As a general rule, the amount of unearned income to be excluded should be determined by an analysis of individual transactions. Nevertheless, it is recognised that there may be special circumstances—e.g. a great volume of transactions—in which a detailed analysis is not practicable. In such a case the taxpayer may apply to the Deputy Commissioner of Taxation with a view to adopting a method of estimating unearned income which can be shown by experience to produce a reasonable approximation of the actual amount” (CCH, *Federal Tax Reporter*, para. 12-005).

11.103 The same statement by the Commissioner insists that the taxpayer should have kept his financial accounts in accordance with the accounting practices accepted by the High Court to be the general rule. If he has not, the *Arthur Murray* principle will not be applied though its application has been claimed in the taxpayer's return. The statement reads:

> “As you will know, emphasis was laid throughout the judgment on the fact that the appellant company had kept its books of account in accordance with the accounting practices which were declared in the case stated to be the general rule. Accordingly, I am not prepared to extend the principles of the High Court decision to any case where the taxpayer takes advance payments into account in calculating net profit and does not make any adjustment at all for ‘unearned income’ for his own accounting
purposes.

However, it is not proposed to make any distinction between taxpayers who prepare their books of account and published accounts on the basis that advance payments are not income until ‘earned’ (as in the Arthur Murray case) and those who credit the advance payments to the same account as other gross revenue received but make a balance day adjustment, at the close of the year of income, to exclude unearned income from the profit and loss account. These alternative methods use different bookkeeping techniques, but both methods achieve the same practical result in excluding ‘unearned income’ from the net profit for the current year, as revealed by the taxpayer's financial accounts” (CCH, Federal Tax Reporter, para. 12-005.).

It is true that the High Court drew on financial accounting conventions in formulating a principle of tax accounting. But financial accounting and tax accounting are distinct regimes. What the taxpayer is entitled to do in his tax return in order that his return should correctly reflect the derivation of income, should not depend on what he may have done in his financial accounts in following conventions concerned with ensuring that accounts correctly reflect the annual profits of his enterprise.

11.104 Reference has already been made to New Zealand Flax Investments (1938) 61 C.L.R. 179 as a decision prior to Arthur Murray in which the Arthur Murray principle might have been recognised, at least if the Commissioner and taxpayer had not reached an agreement about the law that was inconsistent with the principle, and the taxpayer had not failed to raise by his objection a question whether some part of the receipts was not income. The case affords an illustration of how receipts and outgoings accounting, in the absence of an Arthur Murray principle, can bring about a failure to match receipts and outgoings and a consequent stark injustice. The injustice in this instance was to the bondholders whose subscriptions, so far as they had not yet been spent in performing the services promised by the taxpayer, would go in payment of tax by the taxpayer company. That tax was imposed on an amount which, despite the warping of other principles by the High Court so as to mitigate the failure of matching, could not be said to reflect any overall gain by the taxpayer company. A proposition is asserted in Pt I (Proposition 4, [2.38]ff. above) that an item, to have the character of income, must be a gain by the taxpayer who derived it. In that context the concern is with the individual item derived, and the need to put out of any tax account an item that has not been derived beneficially, or has been derived subject to obligations to apply the amount in the interest of a person from whom it was received or in reimbursing a loss or outgoing incurred in the interests of the person from whom the item was received. The principle now asserted is that the balance of receipts and outgoings which is identified as taxable income should reflect an overall gain, in the sense that there is a balance of the amount of income items
over matching expenses. It is true that receipts and outgoings accounting, without an Arthur Murray principle, will ultimately, in the sum of experiences of several years, bring out a balance that is an overall gain. But a failure to match receipts and outgoings in any of those years will preclude a balance that is an overall gain in that year. It is small comfort to a bondholder in a New Zealand Flax situation that the taxpayer will in subsequent years very likely show negative taxable income (losses in the s. 80 sense), more especially since there is no carry back of that negative taxable income. It will be of no comfort at all if the moneys he has subscribed for bonds are consumed in the payment of tax on positive taxable incomes of the taxpayer in early years, so that the taxpayer is denied the funds that would have been used in carrying out its obligations to bondholders, and the taxpayer is forced into liquidation.

11.105 The tax accounting in New Zealand Flax should have reflected both Proposition 4 (as it is more particularly expressed in Proposition 7—the contribution to capital principle) and the principle later established in Arthur Murray. The receipts from bondholders, so far as they were to be used in buying land to be vested in the bondholders, were not income of the taxpayer, and the use of the receipts in this way did not give rise to deductible outgoings. The receipts in other respects were income, but income derived only as and to the extent that the services of clearing, ploughing, planting and tending the bondholder's land proceeded over the years of income until harvesting of flax commenced. The expenses of clearing, ploughing, sowing, planting and tending would be deductible as they were incurred.

11.106 The assumption in the last paragraph that the principle in Arthur Murray would be attracted by the facts of New Zealand Flax involves a wider view of the principle than that reflected in the Commissioner's statement referred to in [11.102]–[11.103] above. It is true that the progress of performance could only be a matter of estimate, but the uncertainty of estimate is the price of escape from a rigidity in the operation of receipts and outgoings that is simply unacceptable. That price is properly paid.

11.107 The application of the Arthur Murray principle in circumstances beyond Arthur Murray and New Zealand Flax calls for some comment. Clearly there must be some limits on the scope of the principle. Almost any occasion of the derivation of income will carry a prospect that the taxpayer who derives may be called on to take some action—either to make good what he has provided or to pay money—in the event of a contingency that may occur. Where goods or services are provided there are prospects of liability in tort, liability under consumer credit law and liability in contract on the happening of an event—either a defect arising or becoming
apparent, or damage being caused either to the person for whom the goods or services were provided, or another. The deferring of some part of income otherwise derived while there remains any prospect of a liability arising is not required by the *Arthur Murray* principle.

11.108 It is arguable that there is room for the *Arthur Murray* principle where an express promise has been given to make good within a specified period. The promise would be recognised in financial accounting by a provision for unexpired warranties. But a promise to make good in the event of a contingency—a defect arising or becoming apparent—is different from a promise to give service for a period, that is not dependent on a contingency occurring, and it may be that the *Arthur Murray* principle is appropriate only in the latter situation. The obvious illustration is “free” service for a period promised on the sale of a motor vehicle or other consumer durable.

11.109 Where a contract relates to the sale of goods an amount received that is not contingent on delivery of the goods will, apart from the *Arthur Murray* principle, be income derived at the moment the receivable arises. Where the receivable is contingent on delivery there will be a derivation apart from *Arthur Murray*, when there is an actual receipt, for example the receipt of a deposit, and the amount received is not held in trust. In these circumstances the *Arthur Murray* principle will defer derivation until performance. In this instance only one act of performance, the giving of delivery, is contemplated, and derivation will be deferred of the whole amount receivable or received until delivery is given. This operation of the *Arthur Murray* principle is recognised in the Commissioner's statement referred to in [11.102] above.

11.110 A taxpayer who is entitled to an amount payable as a subscription to a periodical publication for a stated period has derived income, apart from *Arthur Murray*, if his right to receive is not contingent on actual delivery of some or all of the issues of the periodical to which the subscription relates. *Arthur Murray* will however require a deferral of derivation so that only so much of the receivable as may be regarded as relating to issues of the periodical delivered in the year of income will be regarded as income derived. *Country Magazine Pty Ltd (1968)* 117 C.L.R. 162 is authority for this operation of the *Arthur Murray* principle.

11.111 An amount receivable under an insurance policy that gives cover for an agreed period will be income derived under the *Arthur Murray* principle to the extent that the period of cover falls within the year of income. It is a short step from this operation of the *Arthur Murray* principle in relation to insurance, to an operation that will defer derivation of a passive income receivable, otherwise held to be derived, so that it is
income derived only to the extent that it is in respect of a period that falls within the year of income. It would be asserted that interest accounted for on an accruals basis, as in National Bank of N.Z. Ltd v. C.I.R. (N.Z.) (1977) 77 A.T.C. 6001, is income derived in tandem with the running of the period of the lending to which it relates. Generally an entitlement to receive interest will be contingent on a period of the lending having elapsed, in which event there will be no room for the operation of the Arthur Murray principle. There will be no derivation until the period has elapsed because the entitlement to receive is until that time contingent. When the contingency is satisfied, the interest receivable will have been fully “earned” in the sense in which that word is used in Arthur Murray.

11.112 If Arthur Murray (1965) 114 C.L.R. 314 may operate to defer derivation of interest income, it may equally operate to defer rent and royalty income. The Commissioner's statement referred to in [11.102] above denies the relevance of the Arthur Murray principle: “... nothing that was said in the judgment (in the case) appears to have any bearing on the point of time at which rents, rentals of plant or machinery or investment income should be regarded as being derived.” It is true that the language used in the statement of principle in Arthur Murray contemplates the kind of future performance with which the case was concerned—that might be called active performance as distinct from forbearance. A distinction in terms of action and non-action, assuming it can always be drawn, would distort the operation of the principle. A receipt of interest or rent in advance under an agreement will require an implication that the receiver will not exercise any power he may have to terminate the tenancy or recall the loan during the period to which the receipt relates. And where he has no power, there are duties to forbear from wrongful interference. Duties to forbear should be held sufficient to attract the operation of the principle.

11.113 The decision in Arthur Murray is concerned with the deferring of receipts otherwise derived. It does not authorise the anticipation of a receipt that will not otherwise be derived until a later year of income. It would not authorise a conclusion that the income item in Squatting Investment Co. Ltd (1954) 88 C.L.R. 413—a receipt in respect of wool submitted for appraisal years before—was income of the year in which it was submitted, though it may be thought that it was fully earned, in the Arthur Murray sense, in that year. At the time of the submission of the wool there was no entitlement to receive or claim of right to receive an ascertained or ascertainable amount. An entitlement and a claim to receive arose years later, when legislation was enacted providing for a distribution of the surplus realised on the sale of wool that had been submitted. Any
principle that would bring back the derivation of the item in *Squatting Investment* to the year in which the wool was submitted would, in any event, be unacceptable as a matter of tax procedure. There would be nothing in the Commissioner's powers to amend an assessment to enable him to reopen an assessment and include the item of income as an item derived in the year in which wool was submitted for appraisal.

11.114 In confirming the operation of the *Arthur Murray* principle in the context of receipts in respect of subscriptions to periodicals, *Country Magazine Pty Ltd* (1968) 117 C.L.R. 162 may have revealed difficulties posed by tax procedure where the principle operates. There will always be difficulties arising from the very limited powers the Commissioner has to reopen assessments, if a new statement of principle conflicts with assumptions that had previously been made. There will, more especially, be difficulties for the taxpayer if an item of a kind that had been assumed to be and had been returned as income of an earlier year is now held, in the affairs of some other taxpayer, not to have been an income item at all. *Country Magazine* concerned an item—a receipt of a subscription for a periodical some numbers of which would appear in later years of income—that was undoubtedly of an income nature. It had however been treated as income derived as to the whole of its amount in the year of receipt. The decision in *Arthur Murray* (1965) 114 C.L.R. 314 thereafter revealed that it was only in part income derived in the year of receipt. In other parts it was income derived in subsequent years. *Country Magazine* confirmed that the amounts derived in those subsequent years must be returned and assessed in those subsequent years. There is some reference in the case to the possibility of an amendment of the assessment of the year of receipt. It is not easy to see what power the Commissioner would have to reopen that assessment: the including of the whole amount of the receipt as income in that year is not an error in calculation or a mistake of fact (s. 170(4)). In the statement to which reference is made in [11.102] above, the Commissioner foresaw the circumstances of *Country Magazine* and asserted that an assessment made in an earlier year when the whole amount of the receipt had been included could not be amended “unless the taxpayer's rights are protected by an undetermined objection or appeal”.

11.115 *Country Magazine* suggests a question about the operation of the *Arthur Murray* principle that requires an answer. The method of spreading forward the amount of a receipt over the years of “earning” may not produce an accurate distribution. The Commissioner's statement referred to in [11.102] above, seeks to deal with this matter:

“It will be clearly understood that nothing in the High Court judgment supports a
proposition that taxpayers can escape tax altogether in respect of income which, although received beneficially will never have to be ‘earned’. For example, many coaching colleges collect the full fees for a course over a relatively short period irrespective of the time the student may take to complete the course. A percentage of students will inevitably drop out from their courses and, after a time, the taxpayer can properly treat such income as being ‘earned’ by default. Taxpayers in this situation normally make adjustments in their accounts so that receipts will be treated as income after a reasonable time has elapsed if there is no longer any reasonable likelihood that the taxpayer will be called upon to ‘earn’ the income. Provided that the taxpayer adopts some reasonable method for bringing such receipts to account as income in due course, his method will be accepted for income tax purposes.”

In this and other paragraphs of the Commissioner's statement there is an assumption that spreading is a matter of estimate and that a new estimate may be made in a year subsequent to the initial estimate. The Commissioner's concern is with underestimate in earlier years and the need for an exaggerated estimate of the amount earned in a later year to ensure that the whole amount is brought to account over a span of years. It should follow that it is proper to redress an overestimate in an earlier year, perhaps the first year, by an underestimate in later years. There might thus be a way of overcoming the unfairness of *Country Magazine*, and of allowing a flexibility within the *Arthur Murray* principle comparable with the flexibility contemplated, in another context, by the decisions in *Commercial Union Assurance Co. Ltd* (1977) 77 A.T.C. 4186 and *R.A.C.V. Insurance Pty Ltd* (1974) 74 A.T.C. 4169. Those cases assume that an estimate of a liability incurred in one year may, in effect, be corrected by new estimates in subsequent years.

11.116 The possibility of a principle of tax accounting applicable to outgoings, that would be symmetrical with the principle in *Arthur Murray* in relation to income items, has been explored in a number of places in Pt II of this Volume. Apart from some observations in the House of Lords in *Strick v. Regent Oil Co. Ltd* [1966] A.C. 295, no overt consideration has been given in the cases to this possibility, though it might be thought now to be tacitly recognised by the Federal Court in *Australian Guarantee Corp. Ltd* (1984) 84 A.T.C. 4642. The taxpayer in *Arthur Murray* deferred items of income—fees in advance for lessons—not yet earned, and at the same time deferred expenses—commissions payable to agents who sold the lessons—referable to the items of income not yet earned. No reference is made to this circumstance in the judgment in *Arthur Murray*.

11.117 Such a principle would have afforded a simple and fair solution to the issue of the deductibility of the payment of interest in advance in *Ilbery* (1981) 81 A.T.C. 4661. If the advantage obtained by the payment is not of such significance as to be treated as structural, so that any deduction for the
interest paid in advance is denied, the advantage is to be seen as a wasting revenue asset, and the payment should be treated as incurred as the benefit arising from the payment is consumed. The benefit will be consumed as the period of use of the money borrowed elapses. Payment of the interest will not be a moment of incurring. Incurring will arise when the outgoing is consumed by the use of the benefit that results from the outgoing. An outgoing thus incurred will be deductible if it is relevant to the derivation of income. It will be relevant, in the case of an interest outgoing, if the money borrowed is, at the time of consumption of the interest, used in a process of income derivation.

11.118 On such a principle interest paid in advance will not be deductible if in the year of consumption the money borrowed is not used in a process of income derivation. It will not be deductible because it will not be relevant to a process of income derivation. In *Ilbery* consumption and relevance in the year of income could have been shown as to only a small fraction of the interest paid in advance. Consumption and relevance might have been shown in subsequent years if the money borrowed had continued to be used in a process of income derivation. The reasons given by Toohey J. for denying any deduction put at the forefront a failure to satisfy the contemporaneity requirements. The payment of interest came too soon—some minutes, presumably, before the money borrowed came to be invested in an interest bearing account. Contemporaneity in such circumstances is a bizarre basis of decision. It is simply a trap for the unwary. Contemporaneity may be a useful enough guide to relevance of an outgoing incurred that relates to a benefit already consumed, or that is consumed immediately. It has no role in relation to a benefit that will be consumed in the future.

11.119 If a principle which relates incurring to the consumption of resulting benefit is adopted, the payment of interest may give rise to some deductibility, notwithstanding that the payment occurred at a time when there was as yet no process of income derivation, actual or even intended. If the money borrowed comes to be used in a process of income derivation, there will be an incurring by consumption and an allowable deduction of so much of the interest paid as relates to the period of such use.

11.120 The observations in the immediately preceding paragraphs concern interest paid in advance by a taxpayer on a cash basis in relation to the item. Where the taxpayer is on an accruals basis in relation to an item of interest, the principle that an outgoing is not incurred until the benefit arising from it is consumed will be applicable to the arising of a liability to pay interest that would in other respects be an incurring of an outgoing. A taxpayer will have undertaken a liability to pay interest in the contract of
loan. That liability to pay, if it is in other respects the incurring of an outgoing—it is ascertained and not contingent—will attract the operation of the principle. The principle will have little apparent room for operation where interest is payable in arrears and an outgoing is not yet incurred because the liability to pay is contingent on the continued running of the loan. Another principle, that there is no incurring while a liability remains contingent, in these circumstances has an overlapping operation with the principle that an outgoing is not incurred until the benefit arising from the liability is consumed. Where, however, there is no right to repay in advance of a specified time and no right in the lender to demand repayment before that time, and the taxpayer is obliged to pay interest on repayment at that time, there is need of the operation of the principle. The liability to pay interest on repayment of the loan should not give rise to a deductible outgoing on the receipt of the loan moneys by the borrower. The principle requiring consumption of the benefit of use of the money would ensure that the liability to pay interest is a deductible outgoing as and to the extent that the period of the loan runs. The principle found such application in *Alliance Holdings* (1981) 81 A.T.C. 4637 and in *Australian Guarantee Corp. Ltd* (1984) 84 A.T.C. 4642. These cases express the principle in relation to a liability to pay interest at the end of a fixed period of borrowing where there is no right to repay in advance or to demand repayment in advance. The liability to pay that arises at the time of the borrowing is not contingent and its amount is ascertained. The benefit arising from the liability to pay interest is the use of the money borrowed. If that use is in a process of income derivation, the principle will allow deduction of the interest to the extent of the amount that relates to the use of the money in the year of income. *Australian Guarantee Corp. Ltd* also endorses the principle where the liability to pay interest is defeasible because the contract of loan provides for an option in the borrower to repay the loan before the end of the fixed period, or an option in the lender to demand repayment of the loan before the end of the fixed period. *James Flood Pty Ltd* (1953) 88 C.L.R. 492 recognises that a liability to pay that is defeasible may be an outgoing incurred. If the outgoing is immediately deductible there is the prospect of the recognition of an item of income if the defeasance occurs. That point is made in [11.78] above. The application of the principle that there is no incurring of an outgoing until the benefit arising from it is consumed, precludes any need to recognise income on the defeasance occurring. The outgoing otherwise incurred will only be deductible as the running of the loan proceeds, and the liability to pay becomes pro tanto absolute. If the repayment of the loan in advance of the end of the fixed term has a consequence that the liability to pay interest
for the remainder of the term is discharged, there will never be an incurring of the liability to pay interest in respect of the remainder of the term. These observations are relevant only to a loan under which the liability to pay interest in respect of a fixed term is absolute or defeasible. If the liability to pay is contingent there will not be any incurring of a liability until the contingency occurs and Australian Guarantee Corp. Ltd will not be applicable. If there is a clause in the loan agreement that the lender will not be entitled to interest for any part of the term if he exercises an option to claim repayment before the expiration of the term, the borrower's liability to pay interest is contingent, and there will be an outgoing incurred only as interest is paid.

11.121 The principle argued for, like the Arthur Murray principle, brings about a matching of receipts and outgoings, though the total achievement of both principles must always be less than may result from specific profit accounting. Profit accounting will bring about matching of all costs and proceeds at the time a profit or loss is to be struck. Arthur Murray (1965) 114 C.L.R. 314 cannot assist matching when income is fully earned prior to any incurring of an outgoing, for example outgoings that are the making of payments for long service leave (Nilsen Development Laboratories Pty Ltd (1981) 144 C.L.R. 616 and s. 51(3)). And the symmetrical principle applicable to outgoings will not assist matching if the benefit arising from an outgoing is fully consumed before there is any related income derivation. An insurance premium for cover of factory premises may be fully consumed before the factory has yet produced any goods, or before those goods are sold. In such circumstances there is some prospect that deduction may be denied altogether by the contemporaneity principle, but in the view of this Volume, wrongly. The contemporaneity principle makes no contribution to the achievement of matching.

**Accounting for Receipts on a Cash basis**

11.122 There is no general principle that will answer all questions as to when there is a derivation by a taxpayer on a cash basis in relation to an item. Rules are required for particular situations.

11.123 The question whether there is a receipt that is a derivation of income when an item is to be accounted for on a cash basis may arise in circumstances which concern only the taxpayer and the person from whom the receipt by the taxpayer proceeds. Or it may arise where action by the taxpayer in relation to his expectation of a receipt or a right to a receipt, will bring about an expectation of a receipt or a right to receive in another person or an actual receipt by that other person. The emphasis in present
discussions is on the question as it arises in the first situation. The question in the second situation is the subject of a closer examination, in connection with the assignment of income, in Chapter 13 below and in [11.140]–[11.143] below.

11.124 The present discussions are concerned with derivation in its meaning in ordinary usage, and with possible extension of this meaning of derivation by s. 19 of the Assessment Act. They deal in turn with derivation where the item is money and then with derivation where the item is something other than money. A distinction is drawn between derivation that involves an actual receipt—where everything has been done to vest the item in the taxpayer as completely as the nature of the item will allow—and derivation that involves a constructive receipt. An actual receipt, in the case of an item of money, will involve the taxpayer acquiring money in hand. A constructive receipt that may be a derivation will involve something more than the arising of a receivable in money. How much more calls for examination.

11.125 Section 19 reflects the distinction between an actual receipt, in the sense adopted above, and a constructive receipt. It distinguishes a situation where an item of an income character has been “actually paid over” to a taxpayer and a situation where the item has been “reinvested, accumulated, capitalised, carried to any reserve, sinking fund or insurance fund however designated, or otherwise dealt with on his behalf or as he directs”. It will be noted that the language of the section suggests concern only with items of money income, leaving derivation in the case of other items to be governed by the ordinary usage meaning of derivation.

11.126 The judicial consideration of the scope of constructive receipt has concentrated on s. 19 of the Assessment Act, and the question whether s. 19 extends or limits the ordinary usage meaning of derivation has been given little attention. The words of s. 19 referring to constructive receipt situations are so broad that the section on its face can only extend the ordinary usage meaning of derivation in its application to items of money, and in its application to circumstances not involving assignment of income. There is some prospect however that s. 19 might be held to have limited the ordinary usage meaning of derivation in its application to assignment of income situations. That prospect is rejected in the discussion that follows in Chapter 13 below.

11.127 One thing would appear to be clearly established: s. 19 leaves the ordinary usage meaning of derivation untouched, in the respect that the ordinary usage meaning would insist that “to see whether income has been derived one must look to realities”. The quotation is from the judgment of Rich J. in Permanent Trustee Co. (1940) 6 A.T.D. 5. The context of the
In the present case the interest was by the deed carried to the capital account and in this sense capitalised. But, s. 19 does not say that wherever this happens income shall be deemed to be derived but it says that it shall be deemed to be derived income on the assumption that it is income and in other respects is derived, notwithstanding that there is no actual payment over but a capitalisation or other dealing on behalf of the taxpayer or under his direction. The object is to prevent a taxpayer escaping though his resources have actually been increased by the accrual of the income and its transformation into some form of capital wealth or its utilisation for some purpose. If, when the deceased entered into the deed of dissolution of partnership, he had obtained an investment for the moneys due to him including interest adequate to cover it, providing him with the equivalent in a capital form of everything due to him, the case might not have been very different from that of a man who obtains a cheque for interest from the debtor and hands it back to him as part of a new investment on fixed mortgage on adequate security. But here the facts show that the deceased got nothing except a new obligation to pay in exchange for an existing obligation to pay. He was no nearer getting his money or of transferring it into anything of any value. His debtor could neither pay nor secure payment of the debt to him except by charging it on property already heavily mortgaged and quite incapable of producing a surplus out of which the amount representing interest could be paid. To see whether income has been derived one must look to realities. Usually payment of interest by cheque involves a receipt of income but payment by a valueless cheque does not. ‘For income tax purposes receivability without receipt is nothing,’ Law of Income Tax (Sir Houldsworth Shaw and Baker), p. 111. You do not transform interest into an accretion of capital by writing out words on a piece of paper. There must be some reality behind them. Some accretion of value to corpus. The facts in this case show that there was not ‘an actually realised or realisable profit’: (Cross v. London & Provincial Trust Ltd [1938] 1 K.B. 792 at 798). All that happened in this case was to change a forlorn hope of interest into a still more forlorn hope of capital.”

The judgment of Rich J. is relied on by Gibbs J. in Brent (1971) 125 C.L.R. 418 for a conclusion that a taxpayer on a cash basis who is owed money for services rendered does not derive the money by not asking to be paid. Such a conclusion could not be doubted without abandoning any distinction between accruals and cash tax accounting. However, Gibbs J. made an observation that may be thought to draw from the judgment of Rich J. more than could have been intended. He said (at 430–431): “In the present case, even if the money had been retained at the request of the [taxpayer], her position would have remained exactly as it was; the income would not have been used on her behalf and the company would have remained under an obligation to pay it to her. There is not the slightest ground in the present case for applying the provisions of s. 19.” The dictum places emphasis on the action of the taxpayer, and whether it is within the
precise words of s. 19. It overlooks the reasoning in the judgment of Rich J. that expresses an overall limitation on any words in s. 19. An event will not be a derivation if there is no reality behind the event: an event that may in other circumstances be a constructive receipt that is a derivation will not be such if in reality the taxpayer was “no nearer getting his money or of transferring it into anything of any value”. It may be that a request not to be paid is not in any circumstances a constructive receipt that will amount to derivation by a taxpayer on a cash basis, but the judgment of Rich J. in Permanent Trustee affords no authority for such a proposition. Nor is authority to be found in St Lucia Usines & Estates Co. Ltd v. Colonial Treasurer of St Lucia [1924] A.C. 508, which decides no more than was decided by Rich J.

11.129 Permanent Trustee (1940) 6 A.T.D. 5 is authority that an event involving only the taxpayer and the person from whom an item of money is receivable will not be a derivation if there is no commercial prospect of an actual handing over of money to the taxpayer. If there is such a commercial prospect, the question remains whether the event is one that either the ordinary usage meaning of derivation or s. 19 would regard as a derivation.

11.130 The event that is the subject of the observation by Gibbs J. in Brent—a request not to be paid—may not be of sufficient significance to be recognised as a derivation, though failure to recognise it as such opens opportunities for postponing the derivation of income. At the same time a request by a taxpayer creditor not to be paid is different in legal significance from a tender of payment by the debtor. A tender does have an effect on the legal relations between debtor and creditor. It would be possible to hold that a tender refused involves a derivation, though a request by the creditor that the debtor should not tender does not.

11.131 It may be argued that there is an event of sufficient significance if the debtor acknowledges his liability by a credit to the account of the taxpayer in the debtor's books of account. It has gone unquestioned since the inception of the income tax that a taxpayer on a cash basis in relation to the item derives interest that is credited to his current or savings account by his bank. In these circumstances the crediting is done with the actual or implied assent of the taxpayer, the implied assent arising from the practice of banks. And the crediting brings about a change in the relationship of debtor and creditor, in that the amount of interest becomes subject to the methods of obtaining payment—a cheque or withdrawal notice—applicable to a current or savings account. Crediting in other circumstances—where no change in legal relations will result—even with the assent of the taxpayer may not be sufficient.

11.132 Treating a crediting as a derivation of an item to be accounted for
on a cash basis does not raise any conflict with the words of the Assessment Act. In a number of instances the Assessment Act by express provision treats an item as derived when it is “paid” to a taxpayer (for example s. 26(eb)). In other situations it is enough to constitute a derivation that an item is “paid or credited” to the taxpayer (s. 109, s. 44(1) and the definition of “paid” in s. 6). It might be inferred that “paid” reflects the meaning of ordinary usage derivation where the item is to be accounted for on a cash basis and “crediting” is an extension beyond ordinary usage derivation. There is, however, nothing in the authorities that supports an equating of ordinary usage derivation and “paid”. The fact that an item is held to have been “paid” might suggest that it has been derived within the ordinary usage meaning. But “paid” may have different meanings in different contexts, and is thus an uncertain guide to the ordinary usage meaning of income. It should not be taken to determine exclusively the ordinary usage meaning.

11.133 As explained in [11.128] above, Permanent Trustee (1940) 6 A.T.D. 5 and St Lucia [1924] A.C. 508 are not authority that a “capitalising” of a receivable is never a derivation of an item accounted for on a cash basis. “Capitalising” is of course a term of several meanings. The capitalising in Permanent Trustee was no more than an acknowledgement that an amount was owing to the taxpayer that had its origin in an obligation to pay interest, and the addition of a security over certain property in respect of the amount owing. Such an acknowledgment ought not to have greater significance than a crediting which brings about no change in legal relations. The giving of security does not of itself change the nature of the indebtedness, though it does bring about additional legal relations between the parties. A change in legal relations going to indebtedness itself may be the appropriate test of a constructive receipt that will be a derivation. It will follow that an agreement that an amount owing by a debtor should be treated as a loan made by the taxpayer to the debtor will be a derivation, more especially if it is agreed that the loan will bear interest. Such a “capitalising” is effected by the crediting by a banker of interest to a savings account, and may be another reason why such a crediting should be treated as a derivation. There is an observation by Mason J. in Brookton Co-operative Soc. Ltd (1981) 147 C.L.R. 441 at 455-6:

“Payment of a dividend may occur in a variety of ways not involving payment in cash or by bill of exchange, as, for example, by an agreed set-off, account stated or an agreement which acknowledges that the amount of the dividend is to be lent by the shareholder to the company and is to be repaid to the shareholder in accordance with the terms of that agreement. It is, however, well settled that the making of a
mere entry in the books of a company without the assent of the shareholder does not establish a payment to the shareholder (Manzi v. Smith (1975) 132 C.L.R. 671 at 674). In the present case the taxpayer accepted the correctness of the entry made by Tunwin in its books. This acceptance, it is said, constituted an agreement which amounted to payment. The argument is that from this acceptance there is to be implied an agreement that the amount was lent to Tunwin on terms that it was payable on demand. But the resolution of the Tunwin directors on 29 April 1973 said nothing about loan or deposit; it merely stated that the dividend was to be payable on demand. The resolution passed by the taxpayer's directors on 15 May 1973 did not evidence any agreement to lend moneys to Tunwin; on the contrary, it indicated that the taxpayer was awaiting payment so as to enable it to make an investment ‘on fixed deposit’.

11.134 The case involved a notion of payment for purposes of a power under Articles of Association of a company to “pay” an interim dividend, and has no direct bearing on what is a derivation of income. The observations of Mason J. may none the less suggest a conclusion that a capitalising by an agreement that a receivable shall be treated as moneys lent by the taxpayer to a debtor is a derivation of the amount receivable by the taxpayer. It may be noted that Mason J. did not regard a crediting, even with the assent of the taxpayer, as a payment save where it had the effect of bringing about a loan of money by the taxpayer.

11.135 The reference to payment by the making of a loan arrangement, in the passage quoted from the judgment of Mason J., concerned an arrangement made in relation to a debt that had already arisen. There is a question whether a loan arrangement operating on a debt will bring about a derivation where the arrangement was made before the debt arose. An agreement may be made that interest to become receivable in the future will be treated as capital and itself bear interest. It is arguable that there is no derivation in the circumstances, though a conclusion which adopts that argument may have unacceptable implications. The prior agreement will be operative to bring about a change in legal relations, such that interest receivable becomes loan money receivable. There is room then for an argument suggested by the conclusions in Constable (1952) 86 C.L.R. 402, that the ultimate handing over of cash to the taxpayer is not a derivation of income by him. What he receives is the repayment of a loan. Such an argument, it must be admitted, may equally be available on the ultimate receipt in the circumstances of Permanent Trustee and St Lucia, though a continued insistence on the need to look to “realities” may rebut the argument.

11.136 A taxpayer may be entitled to receive payment from a debtor, and the debtor may have a claim against the taxpayer. If the effect of an appropriation by either party, or by the agreement of the parties, or by the
operation of a rule of law applicable in the absence of appropriation, is that the taxpayer's entitlement to receive payment ceases, there will be a derivation by the taxpayer of the amount he is entitled to receive. There are no words in s. 19 that would extend to such circumstances, at least where the appropriation is by the debtor, or by operation of law. But there must in such circumstances be an ordinary usage derivation. If interest becomes owing by a bank to its taxpayer customer on a fixed deposit, and that interest is credited to the taxpayer's overdrawn current account there will be a derivation of interest by the taxpayer. And there may also be a payment of interest by the taxpayer on the overdrawn account if the crediting of interest to the overdrawn account, having regard to any agreement of the parties or the operation of a rule of law, brings about a discharge of the interest liability. If there is no ordinary usage derivation by a taxpayer where an entitlement to receive ceases because of some action in relation to an entitlement of the debtor to a payment by the taxpayer, the possibilities of what might be called income swallows by both parties will indicate an unacceptable failure of legal principle. There will be an unacceptable failure if a taxpayer entitled to a receipt of interest is held not to have derived that interest if he buys goods from his debtor, and it is agreed that the debts for interest and for the supply of goods shall be set-off against one another.

11.137 These possible income swallows have affinity with those that are sometimes said to arise from barter transactions. A taxpayer who is a plumber carries out work on the house of an electrician under an agreement whereby the electrician will do electrical work on the house of the taxpayer. There are derivations of income by both parties. In the illustration given the amount of income will in each case be determined by the “value to the taxpayer” in accordance with s. 26(e). In other circumstances s. 26(e) may not be available to determine the amount of income. Owners exchange houses so that each lives in the other's house. The fact that the principle in Tennant v. Smith [1892] A.C. 150 may require a conclusion that there is no amount of income derived by either owner is an indication only of the inadequacies of the law in regard to the valuation of items of income. It does not bear on the conclusion that there are derivations of income by both parties.

11.138 The practice of “handing over of cash”—bank notes and coin—which has been taken to be an undoubted derivation by a taxpayer on a cash basis in relation to an item, has been to a substantial extent displaced by the handing over of a cheque, or a direct credit to the taxpayer's account with a bank or some other financial institution. A cash cheque that has been in fact cashed by the taxpayer will involve a derivation. There may be
a derivation before that time if the taxpayer has chosen to delay cashing the cheque. In these circumstances, the choice to delay might be thought to justify the same treatment as the refusal of a tender. Where the cheque requires collection by a bank, derivation should wait on actual collection by the taxpayer's bank, unless the taxpayer has chosen to delay submitting the cheque for collection.

11.139 Where a debtor directs a transfer of credit from his own account with a bank to an account of the taxpayer with the same or another bank, there will be a derivation by the taxpayer immediately the transfer is irrevocable. Such a rule is directed by the rules in regard to a payment by way of a cheque.

11.140 Questions of derivation of an item of income by a taxpayer on a cash basis arise where a receivable is assigned by the taxpayer to another. The questions are the subject of more general treatment in Chapter 13 below. The rules that apply follow the rules underlying the answers to questions examined in relation to circumstances where the events concern only the taxpayer and the person from whom the receipt proceeds. A disposition by the taxpayer of a right to receive which is involved in an effective assignment, brings about a change in legal relations between debtor and the creditor taxpayer, such that no debt is thereafter owed to the taxpayer. Section 19 does not include words that are obviously appropriate to describe an assignment, but this, it has been argued, does not justify a conclusion that the assignment cannot be a derivation by ordinary usage. There is no reason to treat s. 19 as a code. Indeed observations by Rich J. in *Permanent Trustee* (1940) 6 A.T.D. 5 quoted in [11.127] above might be interpreted so that the section has no operation at all. If emphasis is placed on the word “income” in the opening phrase of s. 19—“income shall be deemed to be derived”—there might be room to suggest that the section has no operation unless an item is already derived, since derivation is an essential quality of an item being income of a taxpayer. The suggestion would leave s. 19 with no operation. It would read, in effect: “Income that is derived shall be deemed to be derived”. The suggestion must obviously be rejected, but the fact that it can be made justifies an assertion that the section should not be treated as a code governing derivation in circumstances other than the actual handing over of money.

11.141 Action by a taxpayer that brings an end to his right to receive is a constructive receipt that is a derivation. There may be room for debate concerning the amount of the receipt. Where a taxpayer who is on an accruals basis has already derived an item that is a receivable, he may suffer a loss by the failure of the receivable to realise the amount of the receivable when it is assigned to another. An objective to equate the
consequences of assignment for accruals and cash basis taxpayers, would direct that an assignment by a cash basis taxpayer should be treated as a derivation, not of the amount of the receivable, but of the amount of its value at the time of the assignment. Treating it in this way would be consistent with the principle established in Permanent Trustee that an event should be judged in terms of realities. It would not accord with realities to treat the taxpayer as having derived the amount of a receivable when the financial responsibility of the debtor leaves a doubt that he will ever be able to pay that amount.

11.142 It is of vital importance to a fair and coherent operation of tax law that the assignment of a receivable should be treated as a derivation by a cash basis taxpayer. The decision in Federal Coke Co. Pty Ltd (1977) 77 A.T.C. 4255 confirms a basic principle of income tax law that the character of an item as income must be judged as it comes to the taxpayer. A receivable that has been assigned will not generally be capable of being an income item in the hands of the assignee. A receivable that would have been interest income if it had been derived by the assignor, may not be interest income of the assignee. The assignee may not have taken an assignment of the debt to which the interest relates, so that the item cannot be income in his hands as a gain derived from property. Even if he has taken an assignment of the principal debt as well as of the debt for interest, the receipt of the interest by him as assignee will not be income derived from property. The interest has not arisen from property held by him at the time to which the interest relates. What he receives is simply the payment of a debt that he has acquired. The law ought not to contemplate the possibility that an item is not income of the assignor because the receivable has been assigned, and is not income of the assignee because in the circumstances of receipt by him the item does not have an income character. The possibility is an unacceptable income swallow.

11.143 An assignment needs to be seen differently from an instruction—a mandate—by a person entitled to a receivable, requiring the debtor to pay to another. The mandate remains revocable unless the taxpayer who gave the mandate is bound not to revoke. Even if he is so bound, the mandate does not terminate the obligation of the debtor to pay the taxpayer, in the way that is characteristic of an effective assignment. Action taken by the debtor in pursuance of the mandate, so that payment is made to another, will bring about a derivation by the taxpayer who gave the mandate. The amount of the derivation will be the amount of the receipt by the person to whom payment is made.

Derivation on a cash basis where a right to receive cash is applied so that the
taxpayer becomes entitled to a benefit other than money, or where the item of income is something other than money

11.144 Three situations may be distinguished:

(1) A taxpayer agrees, in advance of a right to receive money arising, that his right to receive will be applied in a specified way by the person otherwise obliged to make the payment and the agreement is not revocable by the taxpayer. Thus it may be agreed that, on the right to receive arising, it will be applied as a subscription to a debenture to be issued by the person otherwise obliged to make payment.

(2) A taxpayer who has a right to receive money agrees, after the right to receive arises, that his right will be applied in a certain way; or fails to revoke a revocable agreement that his right will be applied in this way. A taxpayer may have given a revocable instruction that his right to a distribution of income by a unit trust will be applied in a subscription for new units in that trust.

(3) A taxpayer has at all times a right, not to money, but to some other form of property.

11.145 In situation (2) there will, generally, be a derivation by a cash basis taxpayer when the agreement is acted on. He will derive the amount of money he was entitled to receive, not the value of any benefit or property he received as a result of the application of the money. There is a constructive receipt of the money that is a derivation by the ordinary usage meaning of derivation and by s. 19. The time of derivation will be the time when his agreement is acted on so that any property that is to be vested in him is so vested to the full extent that vesting is possible. The general rule would, presumably, not apply if a handing over of money was not a real commercial prospect and the taxpayer has been offered some other property in substitution for his entitlement to receive money. In these circumstances it is arguable that he has derived so much of the amount receivable as is reflected in the value of the benefit or the property he has received. And an approach in terms of realities might require a conclusion that there is a derivation to the extent of the value of any benefit or property he receives as a result of the application of the money receivable, when that value exceeds the amount of the money receivable.

11.146 In situation (1)—where there is an irrevocable consent by the taxpayer to the debtor applying the receivable in a specified way, the consent being given before the receivable arises—the most likely conclusion is that there is a derivation of the value of any benefit or property received as a result of the application of the money. Permanent Trustee Co. (1940) 6 A.T.D. 5 may be thought to stand in the way of such a conclusion, at least when the property that results is a new debt arising from a loan by the taxpayer to the debtor. But Permanent Trustee did not
consider the question of a derivation of the value of the debt owed to the taxpayer which arose from the capitalising of the interest. And, in any event, the case can have no application where the property that results from the application of the receivable involves rights against persons other than the debtor. The case would have no application, for example, where the arrangement is that money due by a debtor to the taxpayer shall be applied in subscription for debentures in a company in which the debtor is interested.

11.147 The decisions in *W. E. Fuller Pty Ltd* (1959) 101 C.L.R. 403, and in *I.R.C. v. Fisher's Executors* [1926] A.C. 395 in regard to shares and debentures issued as a result of the application of dividends are not inconsistent with the conclusion in the last paragraph. Any principle that those cases establish is concerned with the income character of “bonus” issues and they have no wider application.

11.148 In situation (3)—where the taxpayer cannot be said to have had at any time even a notional right to money—there will be a derivation of the value of any benefit or property received by the taxpayer. The derivation will arise, generally, where the debtor has done all that can be done to vest the benefit or the property in the taxpayer. Where the item of income is options to be issued by a company to its employee to acquire shares in the company, there will be a derivation when an offer of options is made by the company and the employee accepts the offer by paying the amount specified in the offer as the amount payable to secure the issue. Neither *Abbott v. Philbin* [1961] A.C. 352 nor *Donaldson* (1974) 74 A.T.C. 4192 resolves expressly the question whether derivation occurs at this time or at the time of the offer, but derivation at the time of acceptance is the more appropriate. A taxpayer should not be taken to have derived a benefit or property when it remains open to him to reject it.

11.149 Where the item of income derived will be a benefit given or the vesting of property—situation (3), or situation (1) on the view taken in [11.146] above—there is a possibility that the taxpayer may assign the right to the benefit or property to another or direct the debtor to provide the benefit or property to another. In the latter case there will be a derivation by the taxpayer when action is taken on his direction. In the former case there will be a derivation at the time of the assignment. There must be a principle by which a constructive receipt of a benefit or property is a derivation, parallel with a principle by which a constructive receipt of money is a derivation. There will, of course, be problems of valuation of the benefit or the property in determining the amount of the derivation. Proposition 2 ([2.30]ff. above) and s. 26(e) will be operative, with some special nuances when the benefit or property will be or has been conferred.
on or vested in another.

The operation of section 101A

11.150 Where an item is income of a person in all respects save derivation, and he is on a cash basis in relation to the item, his death before a receipt that would have been a derivation will preclude the item ever being derived by that person. And a receipt of the item by his personal representative could not on general principles be income derived by his estate. In the hands of the personal representative the item does not have an income character. So much was decided in *Lawford* (1937) 56 C.L.R. 774, and confirmed in *Carden's* case (1938) 63 C.L.R. 108. Section 101A was added to the Assessment Act in 1941. It makes a receipt by the personal representative a derivation of an item of income by the estate of the deceased, if the item “would have been assessable income in the hands of the deceased person if it had been received by him during his lifetime”.

11.151 The operation of s. 101A where the deceased would have accounted for the item on an accruals basis, was the subject of some comment in [11.66]-[11.72] above. A deceased partner would have accounted during his lifetime on a basis of receivability under s. 92, a basis akin to accruals. *Single* (1964) 110 C.L.R. 177 may be taken to be authority that s. 101A operates if it can be said of an item that it would have been income derived by the partnership—the hypothetical taxpayer under s. 90—and would have given rise to an individual interest in a deceased partner, even though the partnership was on an accruals basis in relation to the item so that an actual or constructive receipt would have been of no consequence. And it may be taken to be authority that the section will operate notwithstanding that the deceased would have derived income under s. 92 on the arising of his individual interest, an actual or constructive receipt by him being of no consequence. The word “received” in the phrase “if it had been received by [the deceased] in his lifetime” must be given a wide meaning, so that it covers an event that would have been a derivation, having regard to the basis of accounting appropriate to the item.

11.152 This interpretation of s. 101A may be thought to have implications in the circumstances of *Carden's* case where there has been a change in basis of accounting from cash to accruals prior to the death of the deceased. It will be seen that an item which became receivable during a year of cash tax accounting will escape inclusion in assessable income of the deceased if it is the subject of an actual or constructive receipt during a subsequent year of accruals tax accounting. It cannot be included in the assessable income of the deceased estate, since it will not be received by
the deceased estate. Where the item remains receivable until death and is
received by the deceased estate, s. 101A will not operate. It will not
operate because a receipt for purposes of a cash basis accounting—the
basis appropriate to the item—would not have been a derivation during the
lifetime of the deceased, unless it had occurred in the year in which the
receivable arose. The interpretation of s. 101A in Single will not, therefore,
enable the Commissioner to overcome the “fall-out” that results from the
change from cash to accruals.

11.153 Single is consistent with a conclusion that s. 101A will operate only
where the income character of the item in the hands of the deceased, save
for the element of derivation, was completely established prior to the death.
Menzies J. observed (at 190):

“It seems to me that, had the deceased at any time during his lifetime received a
share of costs for work done by the firm while he was a member of it, he would have
received assessable income.”

The word “received” in the words quoted, on its face, suggests a
misunderstanding of tax accounting applicable to derivation of income
through a partnership intermediary. If the word is read as “derived” the
difficulty disappears. And the significance of the statement then rests with
the reference to “work done by the firm while he was a member of it”.
Income character will not presumably be established prior to death where
derivation has been deferred by the operation of the principle in Arthur
Murray (1965) 114 C.L.R. 314.

11.154 Where the income character of an item reflects action taken after
death, for example the realisation of an asset, whether it is taken by the
former partners of the deceased or by the deceased's personal
representative, s. 101A will not operate (Spence (1969) 121 C.L.R. 273).
There may be need to draw a distinction between work done by or on
behalf of the deceased before his death under an entire contract—so that
there is no item of income until the work is completed—and work done
under a contract for which there would be at least a right to a quantum
meruit. It is arguable that s. 101A can have no operation in the former
situation, though this might be thought to give undue significance to the
technicalities of the general law in the interpretation of the Assessment
Act.

11.155 Where s. 101A operates in other respects, there will be a derivation
by the estate of the deceased for purposes of s. 95. At least that is the
inference to be drawn from the deeming of the amount to be income to
which no beneficiary is presently entitled, which has significance only in
relation to net income as determined by s. 95. The reference to “receipt” by
the trustee in this instance may be taken to require a receipt that would be a
derivation by a taxpayer on a cash basis in relation to the item.

**Other specific provisions**

11.156 The Assessment Act contains a number of provisions in regard to
the derivation of items which have, or are given, an income character. Some of these provisions give an income character to items that are
specific profits, and the words used in relation to derivation are apt to refer
to the ordinary usage meaning of derivation in relation to such profit. Thus
s. 25A(1) and s. 26AAA refer to “profit arising”.
11.157 In some instances the provision deals only with income character in
respects other than derivation. The intention is clearly that derivation is left
to be determined by the ordinary usage notions of derivation. Section 27H
is an example. It provides that the “assessable income of a taxpayer shall
include the amount of any annuity derived by the taxpayer”.
11.158 In other instances words are used in relation to derivation that may
adopt a meaning that is in some respect different from ordinary usage
derivation. The word “received” is very generally used. Thus it appears in
s. 26(f)—“any amount received as or by way of royalty”; in s. 26(g)—“any
bounty or subsidy received”; in s. 26(h)—“any fee or commission
received”; in s. 26(j)—“any amount received by way of insurance or
indemnity”; in s. 26AB(2)—“receives a premium”; in s. 26AF—“receives
or obtains a benefit”; and in s. 26B—“receives”. The word “received” in
all the illustrations listed should be taken to refer to ordinary usage
derivation. Generally the appropriate basis of tax accounting will be cash,
and it is derivation on this basis that will be required. There will, however,
be occasions when the basis of accounting otherwise appropriate to the
item is accruals, and the word “received” should be taken to require
accruals accounting.
11.159 Where more specific words are used, the inference may be that
some notion of derivation other than derivation by ordinary usage was
intended, and it becomes necessary to identify that notion. The word
“obtains” in the phrase “receives or obtains” in s. 26AF(1), used in relation
to a “benefit of any kind” may have been intended to extend the ordinary
usage notion of derivation in relation to a benefit other than money. It is
not however easy to imagine circumstances which are described by the
word “obtains” which would not be within the ordinary usage notion of a
vesting in the taxpayer to the full extent that vesting of the benefit is
possible. Some argument might be made that the use of the phrase
“receives or obtains” indicates a more limited meaning of the word
“receives” than the meaning suggested in the last paragraph. The argument would be both forced and unfortunate.

11.160 Subsections (5) and (15) of s. 26AAC impose in a number of respects special tests of derivation where the item in question is a share in a company acquired under a scheme for the acquisition of shares by employees. These have been the subject of some comment in [2.25]ff., [2.35], [4.20], [4.82], [4.85] and [4.134] above. There is, however, a question of the significance to be given to the word “acquired” or “acquires” which describes a pre-condition of the application of these special tests.

11.161 The word “acquired” is also used in s. 26AAC in the context of an option acquired and disposed of so that the amount received, less certain costs, is income derived (subss (7) and (8)). It was suggested in [11.57]–[11.61] and [11.148] above that an option is derived when a person accepts the offer of options, not when a right to options arises. Only then is there a vesting of the benefit to the full extent that the nature of the benefit admits. A like meaning should be given to the word “acquired” in its use in relation to options in s. 26AAC. The word “acquired” as an aspect of derivation in relation to shares under subss (5) and (15), may require a similar interpretation, so that at least an actual allotment of shares by the company is necessary. It may be argued that in addition there must have been a registration of the taxpayer, or of a trustee for him, as shareholder. The principle suggested above governing ordinary usage derivation—all must be done to vest the item in the taxpayer that the character of the item admits—might be thought to require registration. However, this may be to press the suggested ordinary usage notion of derivation too far. Unacceptable opportunities to defer the derivation of income would become open.

11.162 Section 27 is concerned with interest on loans raised in Australia by the government of a country outside Australia. It provides that such interest “received directly or indirectly by a resident of Australia, shall be deemed to be derived by him from a source in Australia, and shall be included in his assessable income”. The intention is clearly that an item “received directly or indirectly” by a resident shall be deemed to be derived, and to be derived from a source in Australia. The word “received” has been assumed in previous paragraphs, when used alone, to be equivalent to derivation by ordinary usage. The reference to “directly or indirectly” might base an argument that the word received standing alone is not sufficient to describe ordinary usage derivation. Such an argument should be rejected. It is however possible that an “indirect” receipt will describe situations that are not within derivation by ordinary usage. It is not easy to
imagine what they might be, if, as it has been asserted in [11.144]–[11.149] above, derivation by ordinary usage will embrace payment on the instruction of the taxpayer, and assignment by the taxpayer of a right to receive. One possibility is that an indirect receipt will include a receipt that has moved through the hands of a third party in the manner of the receipt in Constable (1952) 86 C.L.R. 402, considered in [11.171]–[11.172] below.

11.163 A number of provisions adopt the word “paid” in expressing the test of derivation. These include s. 26(eb) (“paid to the taxpayer”), s. 26AC(1) and s. 26AD(1) (“paid . . . to a taxpayer in a lump sum”) and s. 44(1) (“paid to [a shareholder]”). Presumably the context of s. 44 requires that the reference to shareholder is a reference to a shareholder who is the taxpayer. These provisions and s. 26(e) yet to be considered, are unique in framing the test of derivation in terms which look to action by a person other than the taxpayer. At least this is so if we read the words “the assessable income shall include” as providing that there shall be a derivation of assessable income. There is a remotely possible construction of the provisions that they are directed to the income quality of an item in respects other than derivation, leaving the question of derivation to be resolved by ordinary usage principles.

11.164 While it might be accepted that a payment to a person will always involve an ordinary usage derivation by that person, it is unlikely that a payment to a person is a wide enough notion to embrace all circumstances that would be derivations by ordinary usage. Which raises the question whether these provisions exclude ordinary usage derivation, so that, for example, a dividend may be derived so as to be income of a person only if it is paid to him, or, treating the exclusive operation of s. 44 more narrowly, a dividend may be derived so as to be income of a shareholder only if it is paid to him. The implications of the words added to s. 25(1) in 1984 are again raised.

11.165 The respects in which “paid” to a person may have a more limited meaning than ordinary usage derivation concern:

(i) the possible limitation of “paid” to items which are money sums;
(ii) the possible limitation of “paid” so that it does not include any occasions of constructive receipt; and
(iii) the possible limitation of “paid” so that it does not include constructive receipts that arise from the assignment by a taxpayer of a right to receive, or an instruction given by a taxpayer that payment be made to another.

11.166 The possible limitations may be considered in reverse order. The words “paid to” a taxpayer do not easily describe the assignment by the taxpayer of a right to receive. Nor do they easily describe payments made
to a person other than the taxpayer on the instruction of the taxpayer. Perhaps the latter situation is covered: an implication of “by the direction of” after the word “to” is necessary. If that situation is covered, an assignment situation will involve a payment to a taxpayer if the assignment is regarded as an instruction to the debtor to pay to the assignee, and the moment of derivation will be delayed till the instruction is acted on. It would be surprising if derivation under s. 26(eb) of a payment in respect of resumption of work could be avoided by arranging for payment to be made to another.

11.167 The possibility that “paid to” a taxpayer does not cover any occasion of constructive receipt cannot be excluded. It would follow that a taxpayer could avoid tax or defer tax under s. 26(eb) by agreeing that the amount he is entitled to receive should be treated as having been lent to the party from whom he is entitled to receive. He will avoid tax if the subsequent payment of the debt on the loan is regarded as having lost its character of a payment for resuming work. He will at least have deferred tax if it is regarded as having retained that character. Other illustrations of constructive receipts that are derivations by ordinary usage but would not be within the notion of paid to a taxpayer will be suggested by the treatment of constructive receipts in [11.126]–[11.143] above.

11.168 It is arguable that “paid” is a word that cannot embrace the transfer of property other than money. The argument is stronger where the word is used, as it was used, in s. 26(d), in conjunction with the phrase “in a lump sum”. It is used with the phrase “in a lump sum” in s. 26AC and s. 26AD. Where the word “paid” is used without reference to a “lump sum”, s. 21 may be thought to deem a transfer in kind to be a payment. Subdivision AA of Div. 2 of Pt III has replaced s. 26(d), but it does not use the language “paid in a lump sum” and it has express provisions both to require that “payment” (the word used in the definition of eligible termination payment in s. 27A(1)) be treated as extending to a transfer in kind (s. 27A(8)) and to provide for what may be its own code as to what is a derivation. The matter is discussed in [4.23] above.

11.169 In the instance of s. 44(1), however, the argument that paid cannot embrace a transfer of property other than money is at its weakest. A distribution of property other than money is expressly within the definition of a dividend, and the reference to dividends paid in s. 44(1) should be construed in that context.

11.170 “Paid” as used in s. 44 is used in the meaning defined in s. 6, which provides that “paid’ in relation to dividends includes credited or distributed”. There is a question of what may be meant by credited in this context, a question which Mason J. declined to answer in *Brookton Co-
operative Soc. Ltd (1981) 147 C.L.R. 441. A similar question arises in regard to the phrase “paid or credited” in s. 109. The view was suggested in [11.131] above that a simple crediting in the debtor's books of account is not an ordinary usage derivation, even if it is done with the assent of the taxpayer, though it may be different if the crediting brings about a change in the legal relations of the parties. Where s. 44(1) or s. 109 otherwise applies, a simple crediting, at least if it is with the assent express or implied of the taxpayer, may be a derivation.

11.171 Section 26(e) uses specific words to identify the circumstances that will amount to derivation for purposes of that provision. The words are “allowed, given or granted [to the taxpayer]”. Like those provisions which make derivation depend on a payment to the taxpayer, s. 26(e) frames the test of derivation in terms which look primarily to action by a person other than the taxpayer. The interpretation of the words “allowed, given or granted” in Constable (1952) 86 C.L.R. 402 limits their meaning, and raises a question as to the scope of the ordinary usage notion of derivation. Constable did not consider whether the receipt by the taxpayer of cash might involve an ordinary usage derivation of what was otherwise an item of income as a reward for services performed by the taxpayer. One explanation would be that the High Court considered s. 26(e) was a code displacing ordinary usage notions of income derived. There is however no express holding that s. 26(e) is a code, and holding s. 26(e) to be a code has become near impossible having regard to the inference to be drawn from the words added to s. 25(1) in 1984. The other explanation is that the High Court considered that the words “allowed given or granted” expressed a wider notion of derivation than the ordinary usage notion, so that it was unnecessary to consider ordinary usage. This second explanation has important implications for the ordinary usage notion. There may be an occasion which would otherwise be an ordinary usage derivation but the occasion is not a derivation of income because it is too remote from the circumstances which could give the item an income character. The matter was the subject of some consideration in [2.17] and [2.22] above. On one reading of the majority judgment in Constable, the occasion is too remote if it was preceded by a “future and contingent or conditional right” which became “a right to present payment” and which in turn gave rise to the occasion of a present payment. Another reading would direct attention to the majority view on the question of a derivation of income on the making of a contribution by the employer to the superannuation fund:

“... [I]t is, we think, desirable to say that on the frame of the regulations we find it by no means easy to see how the sums so contributed can be regarded as allowed granted or given to the employee when they are paid to the administrators of the
fund. It is only after the administrators have exercised their discretion that any moneys paid to the special account are reflected in the member's (employee's) account, and even then that does not mean that the member becomes presently entitled to the moneys credited to that account” ((1952) 86 C.L.R. 402 at 418).

The precise significance of Constable on the question of remoteness must remain a matter of debate. The case does however support a principle that the course of events between point of origin of an item of an income character and the point that would otherwise be a derivation of that item, may disassociate the item and its derivation in a way that precludes a conclusion that there is income derived. The item is swallowed in transit.

11.172 One observation in relation to the passage quoted might be made. Were it not for the factor of discretion in the administrators, a conclusion that the taxpayer had derived as income a chose in action—an accretion to his interest in the superannuation fund—on the payment by the employer to the fund would have been appropriate. Abbott v. Philbin [1961] A.C. 352 and Donaldson (1974) 74 A.T.C. 4192 would support such a conclusion. In fact Constable has been taken to support a general denial that there is a derivation of income by an employee on payment by an employer to a superannuation fund, even though there is no discretion vested in the administrators.

11.173 Immediately following the passage quoted, there is a statement in the majority opinion:

“We do not think that s. 19 can be used to eke out s. 26(e) and extend its operation or application.”

The significance of that statement can only be a matter of speculation. On one reading it implies that s. 26(e) is a code as to the income character of rewards for services and as to derivation of those rewards, so that s. 19—concerned with ordinary usage derivation—has no room for application. On another reading it asserts a view that ordinary usage derivation and s. 19 would not hold there to be a derivation on the facts before the Court. It is this reading that has been assumed in this discussion.

Accounting for Outgoings on a Cash Basis

11.174 Some argument might be made that no distinction is drawn by the law between accruals basis and cash basis in regard to the deductibility of an outgoing. Reference was made in [11.54] above to the tax accounting adopted by Dixon J. in New Zealand Flax Investments Ltd (1938) 61 C.L.R. 179, which might suggest that a taxpayer on a cash basis in regard to derivation of receipts might be on an accruals basis in regard to the incurring of related outgoings. The case does not however justify any such
conclusion. The assumption now made is that there are distinct principles determining when an outgoing is incurred by a taxpayer who, in relation to the item, is on a cash basis.

11.175 Where the outgoing is a money amount, the word “payment” is an appropriate general description of the occasion that will be an outgoing incurred. It will be evident that payment by a taxpayer on a cash basis in relation to an item will generally be symmetrical with a receipt by a taxpayer on a cash basis in relation to the receipt of that item. Where there is a handing over of cash, there will be symmetry. And there is room for a principle which will in some instances recognise a constructive payment as the incurring of an outgoing. The handing over of a cash cheque will be payment when the receiver cashes the cheque. There should be a constructive payment that is an outgoing incurred if the receiver delays cashing of the cheque. The handing over of a crossed cheque will be an outgoing incurred on the collection of the amount of the cheque. There will be a constructive payment that is an outgoing if the person receiving delays in presenting the cheque for collection.

11.176 A tender of cash should be seen as the incurring of an outgoing even if the tender is refused. A transfer of credit is the incurring of an outgoing immediately the transfer is complete. Symmetry with the principles in regard to derivation by a cash basis taxpayer would suggest that there is not an outgoing incurred if a debtor delays making a tender of payment at the request of the creditor. In the view of Gibbs J. in Brent (1971) 125 C.L.R. 418 the request of the creditor acted on by the debtor is not a constructive receipt that is a derivation by the creditor.

11.177 An appropriation by debtor or creditor, or the operation of a rule of law, that brings about an offsetting of claims will give rise to outgoings on a cash basis symmetrical with derivations on a cash basis. There is some discussion of the offsetting of claims in [11.136] above.

11.178 A crediting by a debtor in his books of account which by express or implied agreement with the creditor brings about a change in legal relations between debtor and creditor will be an incurring of an outgoing by the debtor. The characterisation by Mason J. in Brookton Co-operative Soc. Ltd, quoted in [11.133] above, suggests that the arising of a consequence that an amount otherwise owing by a debtor becomes an amount owing by the debtor under a loan to the debtor is generally an outgoing incurred by the debtor. There would need however to be a qualification to accommodate Permanent Trustee (1940) 6 A.T.D. 5 where, in the “realities” of the matter, there has not been any payment.

11.179 The notion of a constructive payment that is an outgoing is a matter of the interpretation of the word “incurred” in s. 51(1), just as the notion of
a constructive receipt that is a derivation is a matter of the interpretation of the word “derived” in s. 25(1). There is no provision equivalent to s. 19 which may extend the meaning of incurred in the way s. 19 may extend the meaning of derived.

11.180 In one area there will not be symmetry of incurring of outgoing and derivation of receipt. The assignment of a receivable by a creditor will generally involve a derivation by the creditor. But it will not involve an outgoing by a debtor on a cash basis in relation to the item. An outgoing incurred must await action by the debtor of a kind that amounts to an incurring under principles just considered. In the result, there may be a derivation by a creditor on a cash basis in relation to the item, in advance of the incurring of an outgoing by the debtor. Where the creditor does not assign, but gives a mandate to the debtor to pay to another there will be a derivation by the creditor only when the mandate is acted on, and in this instance symmetry will be achieved.

The incurring of an outgoing where the item is something other than money

11.181 In [11.144]–[11.149] above, three situations were considered in relation to derivation by a taxpayer on a cash basis where the item is something other than money. Where there is an agreement between debtor and creditor, entered into before any debt arises, that the amount payable will be applied in a specified way by the debtor, there is room to suggest that the creditor derives the value of any benefit or property be receives as a result of the application by the debtor of the amount payable. This approach treats the events as involving only one transaction—the conferring of a benefit or the vesting of property—and the consequences so far as the creditor is concerned are the same as when he has at all times a right, not to money, but to a benefit or to the vesting of property. Symmetry with this analysis would require that the consequences in regard to deductibility by the debtor should be the same as they are when his obligation has always been to provide a benefit or property.

11.182 Where the creditor, having a right to receive money, agrees that his right will be applied in a certain way, so that he receives a benefit or property is vested in him, there is room for a different analysis. The events may be seen as two transactions: the receipt by the creditor of the money and the application of that money to secure the benefit or property. The debtor will be treated as having made a payment of money which may be the incurring of an outgoing. And he will then be taken to have received an amount equivalent to the amount so paid, in a transaction which may have its own pattern of consequences. The two transactions approach would
presumably not be applicable if the creditor has been forced to accept the benefit or property because cash is simply not available to him. In such circumstances there is room to argue, in terms of the “realities” of the matter, as Permanent Trustee (1940) 6 A.T.D. 5 would require, that there is only one transaction being that under which the liability to pay arose, and the conferring of the benefit or vesting of property are actions taken to discharge that liability. In this event the consequence will be the same as when the creditor has at all times a right not to money but to a benefit or to the vesting of property, the situation next considered.

11.183 The debtor's liability may at all times be a liability to confer a benefit or to vest property. There will of course be an initial question whether the conferring of the benefit or the vesting of the property is an item that may be an outgoing incurred. If it is, the moment of incurring of the outgoing will be the moment when all steps have been taken to confer the benefit or to vest the property as the benefit or property may allow. There may be problems about the amount of the outgoing. Where the debtor has incurred expenses specifically in providing the benefit—where an employer hires a car specifically for his employee's private use—or in obtaining the property to vest in another—an employer buys a car specifically for his employee and transfers it to his employee—the amount of the outgoing may be assumed to be the amount of these expenses. Strictly the amount of the outgoing is the value of the benefit or the property. Section 21 would be applicable. Value, presumably, in this context refers to market value.

11.184 There will not be an outgoing where the debtor provides a benefit or property which it is an aspect of his business to provide and he provides it in the course of his business, or where he provides a benefit or property in the course of an isolated business venture or a transaction within s. 25A (1) or s. 26AAA. A taxpayer who provides a service or supplies goods in these circumstances does not incur an outgoing in the act of providing or supplying. The event will be a realisation of the service or of the goods supplied which may attract other tax consequences. The proceeds of realisation will be income, or will enter the calculation of any specific profit or loss on realisation that is income or deductible. Any deductions by the debtor will have been incurred as costs in providing the service, or in acquiring or manufacturing the goods supplied. There will be problems as to what are proceeds of realisation to be brought to account as income, or to be brought to account in calculating a specific profit that is income. Where the benefit or property is conferred or supplied in return for cash, the cash is clearly proceeds. Where the conferring or supplying is in return for services, the services should not be seen as proceeds in the amounts of
their value, unless an offsetting deduction is allowed of that value. Section 21 will have a theoretical but no practical application. Where the conferring or supplying is in return for goods supplied by the creditor, the proceeds will be the value of those goods and the goods acquired will have a cost equivalent to that value. The occasion is not one for the operation of s. 36. The realisation of trading stock in the circumstances envisaged is a realisation in the ordinary course of carrying on the taxpayer's business.

11.185 If the item of property is a structural asset of the debtor's business, there may be an outgoing incurred and the amount of the outgoing will be the value of the item at the time it is vested in the creditor. In this instance s. 21 has both a theoretical and a practical operation. If the item is depreciable, s. 59 may have an operation, in which event the vesting in the creditor may give rise to a balancing charge or allowable deduction. But this will not affect the deductibility of the value of the item as an outgoing incurred.

11.186 The property to be vested in the creditor may be shares or debentures. Where they are shares or debentures of an entity other than the debtor, the analysis already explained in [11.183]–[11.185] above will be applicable. Where, however, the shares or debentures are shares or debentures of the debtor company, a different analysis is called for. In the case of shares, there cannot be an outgoing incurred in gaining income. The shares may be an income item of the creditor, but they are issued by the debtor in acknowledgment of a subscription of capital. Section 21 has no theoretical or practical application. In this context the distinction between events which may be seen as two transactions—a payment by the debtor and a receipt for property then vested in the creditor—and events which may be seen as only one transaction—the vesting of property in the creditor—is critical. If there are two transactions, the creditor may have a deduction for the amount of the payment in the first transaction. When a company rewards its employees by the issue of its shares or options over its shares, the company is denied any deduction. It is of course true to say that the company has not incurred any expense, though there may be a cost to the shareholders in the decline in the value of their shares resulting from the issue of shares to the employees.

11.187 What is true in relation to its own shares issued by a company, may be thought equally true in relation to its own debentures issued by a company. The debentures are an acknowledgment of an investment in the company. If the issue of the debentures is seen as the only transaction, the company will be denied any deduction. And there may be no deduction on the redemption of the debentures, though at this point there may be room to say that the reality of the matter is an outgoing now incurred in the
transaction out of which the creditor's right to the debenture issue arose.

The operation of section 101A

11.188 Section 101A is confined to receipts, and makes no provision for the allowing of deductions of outgoings in determining the income of the trust estate subject to tax by virtue of the section. A payment by the trustee that would have been an outgoing deductible by the deceased had he paid the amount in his lifetime does not, it seems, generate any tax consequences.

Specific provisions allowing the deduction of outgoings

11.189 The Assessment Act contains a number of provisions, in addition to the general provision in s. 51(1) which allow the deduction of outgoings. The basis of accounting appropriate in the application of these specific provisions is not always clearly specified.

11.190 Some phrases can be construed as leaving the question to be determined by general principles of tax accounting. Thus s. 53 in allowing a deduction for “expenditure incurred” for repairs will presumably allow a deduction of a liability incurred for repairs if the taxpayer is otherwise on an accruals basis. The same observation may be made in relation to s. 64 (expenditure incurred by way of commission for collecting income); s. 67 (expenditure in borrowing); s. 67A (expenditure in discharging a mortgage); s. 68 (expenditure in connection with lease documents); s. 68A (expenditure related to grant of patents); s. 69(1) (expenses of preparing an income tax return); s. 70(2) (expenditure on telephone line); s. 70A(3) (expenditure on mains electricity connection); s. 74 (election expenses); s. 75(1), s. 75A, s. 75B, s. 75C, s. 75D (expenditure on land used in primary production). Section 76 allows the deduction of an “amount expended” by the taxpayer. It may be asked whether these words call for an interpretation differing from the interpretation of “expenditure incurred”.

11.191 Section 53F(2), s. 53G and s. 53H adopt language more clearly directed to importing general principles of tax accounting. The phrase used is “costs incurred”.

11.192 In some instances the language used calls on the word “paid”, and thus adopts cash as the basis of accounting. Those constructive payments that would amount to incurring under s. 51(1) are, presumably, covered. Thus s. 73(1) refers to subscriptions paid by the taxpayer; ss 77B, 77C, 77D, 78(1)(b) and 78(1)(c) refer to moneys, calls, and sums “paid” by the taxpayer.

11.193 In a number of instances a special form of words has been adopted.
Section 53AA refers to an amount “paid to the lessor by, or recovered by the lessor from, the lessee [taxpayer]”. Both phrases would seem to require accounting on a cash basis.

Section 63 is unique in allowing a deduction where the occasion is one that is not an outgoing incurred on a cash or an accruals basis. The section relates to a bad debt and will allow a deduction on the occasion that a bad debt is “written off as such”. A deduction is thus allowable in advance of a deduction that might become allowable under s. 51(1) at some later time. The occasion is simply an accounting entry made in the taxpayer's books of account.

Section 65 seeks expressly to cover both the incurring of an outgoing on a cash basis and the incurring of an outgoing on an accruals basis. The language used is “payment made or liability incurred”. Section 73A may be intended to do the same, though the language is different: “payments made, and expenditure incurred”.

Section 82AAC has a form of words specifying the manner of incurring of an outgoing which is an employer's contribution to a superannuation fund. The words are “sets apart or pays . . . as or to a fund”. The words call for a special exercise in interpretation. Section 78(1)(a) allows a deduction of “gifts made” by the taxpayer. Those words, too, call for a special exercise in interpretation.

Section 51(3) is exceptional in that it is framed so as to work a limitation on what would otherwise be the incurring of an outgoing under s. 51(1). It provides that a deduction is not allowable under subs. (1) in respect of long service leave, annual leave, sick leave or other leave “except in respect of an amount paid to the person to whom the leave relates”, or to his dependant or personal representative where that person is dead. The amount paid is “deemed to be a loss or outgoing incurred at the time when the payment is made”. The deeming ensures that a cash basis applies to the outgoing. The drafting in terms of a negation of s. 51(1) but subject to an exception expressly answers a question that is left open by other specific provisions. There is no concurrent application of s. 51(1). Section 51(3) is restrictive not only in requiring a cash basis but in requiring that the payment be made to the person to whom the leave relates or his dependant or personal representative. Thus s. 51(3) has added another reason why a payment of the kind for which a deduction was claimed in Foxwood (Tolga) Pty Ltd (1981) 147 C.L.R. 278 is not deductible.

The assumption would be that, unless it is otherwise expressly provided, a specific provision provides for deductions in addition to any that may be available under s. 51(1). There is a specific provision in s.
82AAQ in relation to employer contributions to a superannuation fund that parallels the operation of s. 51(3) by denying deduction under s. 51(1). The assumption may be the subject of debate in some instances. Comment is made in Pt II in regard to some provisions, including s. 53 ([10.9] above) and s. 63 ([10.65]ff. above). Section 63 is the subject of further comment in [12.181]ff. below.

**Accounting on a Cash Basis for Receipts and Outgoings “in Advance”**

**11.199** Tax accounting on an accruals basis in relation to an item of receipt otherwise derived, where there is reason to defer recognition of the item as income derived, was examined in [11.89]ff. above. The question now raised is whether deferral allowed by the principle in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314 is available where the item is to be accounted for on a cash basis.

**11.200** The taxpayer in *Arthur Murray* was on an accruals basis in relation to the items, though the items in question were the subject of actual receipts and, the deferral question aside, would have been held derived if a cash basis had been applicable. Indeed a good deal of the judgment of the High Court in the case is in language that would suggest that the question of deferral will arise only in relation to an item that has been actually received. To allow deferral where the item is the subject of an actual receipt, but deny it where the item is a receivable, would make no sense. The principle in *Arthur Murray* must be applicable to a receivable that would otherwise be held to be derived because it is to be accounted for on an accruals basis. A receivable that is not contingent and is for an ascertained amount may be unusual where the taxpayer has yet to take action that is part of the consideration for the receivable. Thus a receivable in respect of goods to be supplied will normally be contingent on the goods being supplied. But the contract may require payment of a sum certain irrespective of delivery. In which case, the deferral question aside, there will be an item of income derived on the making of the contract. The principle in *Arthur Murray* will be applicable to that item.

**11.201** The fact that the taxpayer in *Arthur Murray* was on an accruals basis in relation to the items does not, in itself require that the case be restricted to such a taxpayer. But some of the reasoning in the case may suggest that it is to be restricted in this way. Thus the judgment in *Arthur Murray* asserts (at 318) that “the ultimate inquiry . . . must be whether that which has taken place . . . is enough by itself to satisfy the general understanding among practical business people of what constitutes a
derivation of income”. It might be said that the tax accounting applicable to practical business people is accruals and if the taxpayer is on cash there can be no relevant understanding. The judgment continues: “A conclusion as to what the understanding is may be assisted by considering standard accounting methods, for they have been evolved in the business community for the very purpose of reflecting received opinions as to the sound view to take of particular kinds of items.” It is accruals financial accounting that includes a principle requiring deferral in circumstances such as Arthur Murray.

11.202 When, however, the judgment turns to a detailing of the circumstances that would make it business good sense to defer an income item, a conclusion that the principle is to be confined to a taxpayer on an accruals basis is much less compelling:

“It is true that in a case like the present the circumstances of the receipt do not prevent the amount received from becoming immediately the beneficial property of the company; for the fact that it has been paid in advance is not enough to affect it with any trust or charge, or to place any legal impediment in the way of the recipient's dealing with it as he will. But those circumstances nevertheless make it surely necessary, as a matter of business good sense, that the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed *quid pro quo* not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself. In our opinion it would be out of accord with the realities of the situation to hold, while the possibility remains, that the amount received has the quality of income derived by the company” (1965) 114 C.L.R. 314 at 319).

These circumstances would make it good sense to any taxpayer, including a taxpayer on a cash basis, to defer income recognition. A dentist on a cash basis of returns who insists on an advance payment from his patient for expensive dental work, a barrister on a cash basis who insists on advance payment before appearing for a client in a criminal trial and an employee who receives pay in advance of performing services would think it a matter of good sense, a quality not confined to business people, to treat the amount of fees or salary as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed *quid pro quo* not be rendered in due course.

11.203 The illustrations in the last paragraph of circumstances where the *Arthur Murray* principle should extend to a cash basis taxpayer are all concerned with what might be called active income. If the principle extends to such circumstances, there will be a further question whether it extends to what might be called passive income—income derived from property, in the form of interest, rent and royalties received in advance, or a premium received on the letting of property. It would not be easy to draw
a conclusion from the judgment in *Arthur Murray* that the principle requiring deferral extends to such income. But it is fair to say that there is nothing in the judgment in *Arthur Murray* which would preclude the recognition of a wider principle that would embrace both active and passive income. It is good sense to treat the amount of rent, premium, interest or royalties that relates to the use of property by another in a subsequent year of income as income derived in that subsequent year, and not in the year in which a non-contingent right to receive arises or in which there is an actual receipt. It is good sense not only because the allowing of use by another in that subsequent year is a quid pro quo to be rendered by the taxpayer, but also because there may be expenses, for example for repairs, that may need to be incurred in that subsequent year which ought to be in a matching relationship with the item of income.

11.204 The scope for operation of an *Arthur Murray* principle, whether narrow or wide, will be the less in regard to items to be accounted for on a cash basis simply because receipts that are derivations on a cash basis are the more likely to come after any action to which they relate. Receivability is the earlier event, though receipt on a cash basis may be brought closer to receivability if the receivable is assigned by the taxpayer.

11.205 An *Arthur Murray* principle does not provide for advancing the derivation of an item. Until there is a derivation in respects other than an *Arthur Murray* principle, there can be no derivation under an *Arthur Murray* principle.

11.206 In [11.156]–[11.173] above a number of specific provisions which deal with derivation in particular circumstances are considered. There is a question whether these specific provisions displace the *Arthur Murray* principle and any wider principle which would embrace the *Arthur Murray* principle.

11.207 Two illustrations may be taken. Section 119 provides, so as to displace the operation of the mutuality principle, that “the assessable income of a co-operative company shall include all sums received by it . . .”. It is not difficult to preserve the *Arthur Murray* principle against such drafting. The words used do not require the inclusion of the items in income in the year of receipt. Section 26AB(2) is more awkward. It provides, so far as relevant:

> “Where, in the year of income, a taxpayer receives a premium . . . the assessable income of the taxpayer shall include the premium.”

The reference to “the year or income” may be thought to govern the time of inclusion of the premium in income. Such a conclusion is not a necessary one, and it ought not to be adopted to displace the wider *Arthur Murray* principle. The purpose of s. 26AB (2) is not related to that principle.
In [11.116]ff. above the possibility is explored, in relation both to accruals and cash tax accounting, of a principle symmetrical with an *Arthur Murray* principle that will be applicable to outgoings. An argument may be made that deductibility of a premium paid for insurance cover extending into a later year of income should be deferred in part until that later year. A payment of interest in advance to be accounted for on a cash basis should be deferred and be deductible in the years in which the period of use of the money to which the payment relates occurs. At least that would be the prima facie basis of spreading the interest payment forward. An arrangement can be imagined under which it is provided that interest under a loan for a fixed period is to be at a high rate in early years of the loan, and at a low rate in later years. An advance payment of interest in these circumstances might be spread forward evenly in disregard of the uneven spread of interest under the arrangement. Indeed any principle should be flexible enough, where interest is not expressly paid in advance under such an arrangement, to treat the high interest in early years as paid in part in respect of the use of the money in later years.

Where the items of outgoing are to be accounted for on a cash basis the scope for a principle symmetrical with an *Arthur Murray* principle will be less than will be the case where an accruals basis of accounting is appropriate. Interest payable at the end of a fixed period of borrowing may be prima facie incurred at the time of the borrowing, where the taxpayer is on an accruals basis in regard to the item. A principle that an outgoing is incurred only as any benefit arising from the outgoing is consumed will spread the deductibility of the interest over the period of the borrowing.

A principle that will defer the deduction of a payment of a premium or of interest paid in advance will also apply to rent or management charges paid in advance. The principle has implications for the principle of contemporaneity in its application to payments in advance of the commencement of a process of income derivation. Those implications are examined in [11.118]–[11.119] above, and the view is expressed that want of contemporaneity is an unsound reason for denying deduction when a payment that is made before the commencement of a process of income derivation secures a benefit that is subsequently consumed in that process. It would also be asserted that want of contemporaneity is an unsound reason for denying a deduction when a payment is made after a process of income derivation has ceased, and the payment is in respect of a benefit that was consumed in that process.

The contemporaneity principle defeats deductibility entirely. *Ronpibon Tin N.L. & Tongkah Compound N.L.* (1949) 78 C.L.R. 47 and *Amalgamated Zinc (De Bavay’s) Ltd* (1935) 54 C.L.R. 295 should be seen
as treating a want of contemporaneity as only an indication that an outgoing is not relevant. The observations made by Barwick C.J. and Mason J. in *A.G.C. (Advances) Ltd* (1975) 132 C.L.R. 175 expressing doubts about the scope of the decision in *Amalgamated Zinc (De Bavay's)* support the view that a want of contemporaneity is only an indication that an expense is not relevant. Barwick C.J. and Mason J. thought that a loss realised after the cessation of a business may yet be deductible if its relevance to the business operations is established by the fact that the debt arose in the conduct of the business operations.

**11.212** A principle in regard to outgoings that is symmetrical with an *Arthur Murray* principle in regard to receipts and a reframing of the contemporaneity principle are necessary to preserve the integrity of the income tax. Deductibility where payments precede the commencement of a process of income derivation, or follow its cessation, will not depend on the chance of precise moment of payment. The taxpayer may properly succeed in showing the relevance of an outgoing that is to be treated as incurred in a later year when the outgoing is consumed. He will fail to show relevance if the outgoing must be treated as incurred in the year in which the liability to pay arose or payment was made. A principle symmetrical with *Arthur Murray* will deny the scope for planning to defer tax by payments between associated entities that will be subject to *Arthur Murray* in the hands of the receiver, yet be claimed to be presently deductible by the payer. Such planning is now limited by s. 82KK, discussed in [11.289]–[11.292] below, but a symmetrical principle would in any case deny it any success.

**The Consequences of a Change in the Basis of Accounting**

**11.213** Attention was directed in [11.71] and [11.72] above to the “fall-out” consequences of a change from a cash basis of accounting to an accruals basis. The taxpayer's business operations may have developed to a point where cash is no longer the appropriate basis and the law requires a change to accruals. There is a question whether that point may be reached at some time in the course of the running of a year of income. Perhaps the question is wrongly put in terms of a point of time. It is arguable that appropriateness must be judged by reference to the business activities of the year of income so that a change in basis may only occur as between one year of income and another. Whichever view is correct, the consequence of a change occurring will be that items of income and deduction which would have been derived or incurred at a time before the change if an accruals basis had been appropriate, but were not derived or incurred on a
cash basis before the change, will never be brought to account, save so far as s. 101A may bring them to account. Section 101A is considered in [11.150]ff. and [11.188] above. Where those items would have shown a surplus of assessable income over allowable deductions, the effect of a change in basis of accounting is favourable to the taxpayer. Where there, would have been a surplus of allowable deductions, the effect of the change is unfavourable to the taxpayer.

11.214 Where the change required by the law is from accruals to cash—a change that had apparently occurred in the early affairs of the taxpayer in Carden’s case (1938) 63 C.L.R. 108, and had occurred in the affairs of the taxpayer in I.R.C. v. Morrison (1932) 17 T.C. 325—there will be a double inclusion of those items that had already been derived or incurred on an accruals basis but now come again to be derived or incurred on the principles governing cash basis of tax accounting. Again the outcome may be favourable or unfavourable to the taxpayer, depending on the nature of the surplus.

11.215 A change in appropriate basis of accounting will occur within what is seen as continuing business operations. It is to be distinguished from a cessation of operations in one business and the commencement of operations in another. The items of the earlier business may have been subject to one basis of accounting, and the items of the new business may be subject to the other basis of accounting, but in these circumstances there is no prospect of fall-out of items or double inclusion of items. There may, however, be consequences of a different kind on the movement from one business to another, if assets of the earlier business are taken into the new business. Those consequences are the subject of examination in [12.99]ff. below.

The Identification of a Receipt or Outgoing

11.216 There are problems of identification of a receipt or outgoing, some common both to accruals and to cash accounting, others confined to cash accounting.

11.217 A taxpayer may receive an amount in such a manner that derivation is satisfied so far as it is necessary that he should have received on a cash basis, but a conclusion that there is income derived requires an identification of the receipt. The taxpayer may be entitled to a receipt from another person in payment for services, and that receipt will be accounted for on a cash basis. At the same time the other person may have sought to make a gift to the taxpayer. Any payment made to the taxpayer will need to be identified as a payment for services or a payment to him by way of gift.
if it be assumed that a receipt by way of gift in the circumstances is not income of the taxpayer. An appropriation made by either party, and the general law of appropriation, will bear on the identification. A like problem of identification will arise if the taxpayer accounts for the receipt for services on an accruals basis, and the receipt by way of gift is income as a product of his activity in providing services. A receipt of payment for services rendered would not be a derivation of income: the item will have been derived at the time the taxpayer became entitled to receive, and actual receipt is not an occasion of income derivation.

11.218 The assumption in previous paragraphs is that the whole of one receipt can be identified as having a single character. The question in some circumstances will be whether it is possible to identify within one receipt a part that has an income character, and a part that does not. A payment may have been made to serve two functions, a payment of fees for services due to a taxpayer on a cash basis of return, and the making of a gift to the taxpayer of a kind that does not have the character of income. In this event the question of apportionment of a receipt where some of it relates to an item of an income character and some to an item that does not have that character, is raised. That question was considered in [2.558]ff. above.

11.219 Allsop (1965) 113 C.L.R. 341 suggests planning to mix a payment in respect of an income item with another, that may be a voluntary payment, so that no part of what is received can be identified as an income item and brought to tax. The possibility of such planning makes the principle in Allsop unacceptable.

11.220 Allsop was concerned with an actual receipt, but the principle in the case has an application in circumstances involving an amount receivable by an accruals basis taxpayer. A taxpayer may combine the sale of trading stock with the sale of a structural asset—perhaps an item of plant. The principle opens the prospect that no part of the sale price is income derived.

11.221 Problems of identification of an outgoing parallel those in regard to receipts. There is however one important difference in the law that may be applicable. There is no principle equivalent to that in Allsop applicable to outgoings. At times there are suggestions in judicial opinion of an equivalent principle, for example in the judgment of Fisher J. in Phillips (1978) 78 A.T.C. 4361 such that the whole of an outlay is deductible if any part of it is in respect of a deductible item. But the phrase “to the extent to which” in s. 51(1) provides an authority for identifying an outlay that is not in respect of a deductible item, and the denial of a deduction to that extent.

Receipts Abandoned or Refunded and Outgoings Relieved
from or Repaid


(i) on the consequences of the withdrawal of a claim to a receipt where the taxpayer is on an accruals basis, and of the return to another of an amount received by a taxpayer on an accruals basis; and
(ii) on the consequences of the withdrawal of an acknowledgment that the taxpayer is under a liability where the taxpayer is on an accruals basis, and of the return to him of an outgoing that he has paid.

11.223 Equally there is lack of authority on the consequences of a return to another by a taxpayer on a cash basis of an amount received by him, and on the consequences of the return to a taxpayer on a cash basis of an amount paid by him.

11.224 Some of these matters were considered by the Papua New Guinea Supreme Court in *Commonwealth-New Guinea Timbers Ltd v. Chief Collector of Taxes* (1972) 72 A.T.C. 4048 which purported to rely on Australian authority. The case is authority for Papua New Guinea law that a claim to recover an amount will not be income derived by an accruals basis taxpayer unless it is legally recoverable by him, and that the abandonment of a claim does not generate a deduction for a loss, under the Papua New Guinea equivalent of s. 51(1) of the Australian Assessment Act, nor will it generate a claim to a deduction under the Papua New Guinea equivalent of s. 63 of the Australian Assessment Act. It will be apparent from the consequences of these principles as they operated in the facts of that case that the principles are quite unacceptable. Legal recoverability should not be a test of the derivation of a receipt by an accruals basis taxpayer. A debt that an accruals basis taxpayer has claimed and now abandons should generate a loss deduction under s. 51. A debt that may be written off under s. 63 should embrace any debt that should be brought to account as assessable income, and debt for this purpose is satisfied by a claim to receive made and still sustained by the taxpayer.

11.225 Another principle adopted by the Papua New Guinea Supreme Court—actual receipt by an accruals basis taxpayer of an item not legally recoverable is income derived—is unnecessary if the claim to receive is treated as income derived. Actual receipt is not a tax event save so far as it precludes a loss deduction or a s. 63 deduction.

11.226 The plaintiff in *Commonwealth-New Guinea Timbers Ltd v. Chief Collector of Taxes* had included in its assessable income amounts it
claimed as due to it by the Commonwealth for the years 1962–1968 under an agreement with the Commonwealth that had been approved by the Papua New Guinea *Taxation Agreement Act*, 1952. None of these amounts was ever received from the Commonwealth. A decision of the High Court in 1969 held that on the view the court took of the agreement there never had been any right to recover the amounts. The plaintiff then claimed, in the 1970 year of income, a deduction of the total of the amounts brought to account as assessable income in the 1962–1968 years. The conclusions of the Papua New Guinea court were that the amounts had been wrongly included in assessable income in the 1962–1968 years since they were never legally recoverable, this having been finally demonstrated by the Australian High Court decision. The Collector of Taxes had no power to amend the assessments in respect of those years so as to exclude the amounts from assessable income since, in including them, he had proceeded on a mistake of law—that the amounts were legally recoverable—and the Papua New Guinea Ordinance, like the Australian Assessment Act s. 170, did not empower the collector in the circumstances to correct the mistake of law. The deduction claimed was not allowable under the Papua New Guinea equivalents of ss 51(1) or 63 of the Australian Assessment Act, since those provisions applied only to legally recoverable debts.

11.227 In the 1960 year of income the Papua New Guinea collector had included amounts received by the plaintiff in respect of amounts the plaintiff claimed to be recoverable in the 1958–1959 years—years in which no income tax was levied in Papua New Guinea. The Supreme Court of Papua New Guinea held that the actual receipt in 1960 was a derivation of income, presumably because the 1958 and 1959 receivables were not legally recoverable amounts and thus would not have been income derived in the 1958–1959 years, even if there had been an income tax in New Guinea in those years.

11.228 Logical implications of the judgment of the Papua New Guinea Supreme Court in its application to tax accounting on an accruals basis would appear to be that:

(i) an outgoing is not incurred unless an amount claimed from a taxpayer is legally recoverable from him, and if an amount not legally recoverable from him is allowed as an outgoing, any subsequent declaration of law that the amount is not recoverable from him will not involve a derivation of income by the taxpayer, and

(ii) an outgoing will be incurred if a claim not legally recoverable from a taxpayer is actually paid by him, notwithstanding that he may subsequently have the money restored to him.
11.229 The judgment of the Papua New Guinea Supreme Court does not provide any guidance on the questions whether the repayment by the taxpayer of money which he could not legally have recovered but which he has actually received will be an allowable deduction, and whether the receipt by the taxpayer by way of repayment to him of money which he has paid but which was not legally recoverable from him will be a derivation of income.

11.230 The plaintiff, who at all times had made full disclosure in its returns, found itself defeated on all possible fronts. Which may be enough to demonstrate that the principles adopted by the Papua New Guinea Supreme Court are unacceptable. A taxpayer may claim an amount, not legally recoverable, in year A, receive it in year B and repay it in year C. He may have been assessed for year A on the assumption that the amount claimed was legally recoverable. He must be assessed for year B because he has actually received the amount. An amendment to the assessment for year A so as to exclude the amount is not within the Revenue's powers. When the taxpayer pays back the amount in year C he may or may not have a deduction: the court did not consider this situation. The law as stated by the court may be shown to be equally unacceptable by an illustration involving a claim against the taxpayer not legally recoverable from him, the payment of that claim and the recovery back of the money paid.

11.231 The law as stated by the Papua New Guinea Supreme Court would be inconvenient even under a tax system which gives the Revenue unlimited powers of reopening assessments and unlimited rights to the taxpayer to have assessments reopened. Principles which adopt recoverability at law as a condition of the derivation of income or the incurring of an outgoing will require the determination of general legal issues in relation to the meanest item of alleged income or alleged deduction. The law as to void, voidable and illegal contracts, and the developing body of consumer protection law, which may afford relief to a borrower or purchaser, will plague the administration of the tax laws. The facts must be screened by the law of evidence. The law of evidence may prevent recovery in the absence of a written memorandum.

11.232 Other implications of the judgment of the Papua New Guinea Supreme Court are that an item accounted for on a cash basis is derived if it is actually received even though the taxpayer had no right to recover the amount and notwithstanding that he subsequently repays the amount. And an item is deductible if it is actually paid though there was no legal liability to pay, and notwithstanding that the taxpayer subsequently recovers the amount he paid. No implication can be drawn as to the deductibility and
The Papua New Guinea Supreme Court relied on *Henderson* (1970) 119 C.L.R. 612. The court quoted the following passage from the judgment of Barwick C.J. in *Henderson* (at 650), a judgment with which McTiernan and Menzies JJ. agreed:

“In ascertaining such earnings, only fees which have matured into recoverable debts should be included as earnings. In presenting figures before his Honour allowance was made for what was termed ‘work in progress’. But this, in my opinion, is an entirely inappropriate concept in relation to the performance of such professional services as are accorded in an accountancy practice when ascertaining the income derived by the person or persons performing the work. When the service is so far performed that according to the agreement of the parties or in default thereof, according to the general law, a fee or fees have been earned and (sic) it or they will be income derived in the period of time in which it or they have become recoverable.”

It is true that this passage appears to assert that legal recoverability is a condition precedent to an amount being income derived. But it must be read in context. The Chief Justice was denying that an amount in respect of work in progress could be said to be income derived. The denial was put on two grounds: that the fee had not been earned and that the fee had not become recoverable. Since the decision in *Arthur Murray Pty Ltd* (1965) 114 C.L.R. 314 it has been established that an item is not income derived until it has been earned. His Honour, in insisting that, in addition to earning, the item must have matured into a recoverable debt, did no more than assert that the item must have become a non-contingent and ascertained claim.

Recognition of an item as income derived in accruals tax accounting requires that there be a claim, unqualified by any contingency, to an ascertained amount. It does not require that it be shown that a court would, if asked, order that the claim is recoverable by the taxpayer and *Henderson* should not be taken to decide that it does so require. Recovery by a solicitor of the amount of a bill of costs rendered by him may be denied if the client has taken proceedings to have the bill taxed. *Henderson*, it is submitted, would not be taken as authority that the amount of the bill will not be income derived until the period within which it might be taxed has expired.

It would be natural for Australian courts to seek answers in United Kingdom law to the questions raised by *Commonwealth-New Guinea Timbers Ltd v. Chief Collector of Taxes* (1972) 72 A.T.C. 4048. It is to be noted, however, that the United Kingdom law gives the Revenue a much greater freedom than does the Australian law, in the reopening of
assessments. That freedom is necessary to prevent injustice if the principles asserted by the Supreme Court of Papua New Guinea are adopted. Thus it would be possible in the United Kingdom in the *Commonwealth-New Guinea Timbers* situation to reopen so as to exclude the amounts included in income in the 1962–1968 years. Though the United Kingdom law could thus tolerate the principles of *Commonwealth-New Guinea Timbers* the United Kingdom authorities do not in fact establish those principles and this must tell strongly against them. The United Kingdom authorities support the proposition asserted by the taxpayer in *New Guinea Timbers* that an amount claimed to be recoverable will be taxed in the year of claim. So too, the United Kingdom authorities support a proposition that an outgoing acknowledged by the taxpayer to be recoverable from him will be deductible in the year of acknowledgment. If it is later shown that the amount claimed or the outgoing acknowledged was wrongly claimed or acknowledged, the relevant assessment will be reopened. In thus reopening assessments the United Kingdom law does not proceed on the assumption that the earlier derivation or incurring was wrong and that it is now being corrected. Though some of the cases are equivocal, for example, *Simpson v. Jones* [1968] 1 W.L.R. 1066, they are consistent with the view that to the extent that the amount has been shown not to be recoverable by or from the taxpayer, there is an item of deduction or of income which must be brought to account (*Bernhard v. Gahan* (1928) 13 T.C. 723; *English Dairies Ltd v. Phillips* (1927) 11 T.C. 597; *Ford & Co. Ltd v. I.R.C.* (1926) 12 T.C. 997). This item, being referable to the year of derivation or of incurring of the item now shown not to be recoverable by or from the taxpayer, must be matched with that item and it is for this reason that the earlier assessment is reopened: “Now into what year is this countervailing entry to be put? That is all that arises here” (per Rowlatt J., in *English Dairies Ltd v. Phillips* (1927) 11 T.C. 597 at 606).

11.237 A similarity between the basic tax accounting law in the United States and in Australia, and similarity in the law as to reopening of assessments, suggests that the United States may afford a model for the Australian law. Central to the United States law is a doctrine that a claim of right, as distinct from legal recoverability, is enough to give rise to a derivation of income by an accruals basis taxpayer. The United States law, as it bears on the problems that require solution in the Australian law, might be stated thus:

(1) An item of income will be derived if the taxpayer asserts a claim of right to recover the amount of that item. If in a later year the taxpayer acknowledges that his claim was mistaken, or repays an amount he has in fact received, he will be entitled
in that year to a deduction of the amount he acknowledges not to be recoverable or the amount he has in fact repaid;

(2) An item of income will be derived, even though the taxpayer does not assert a claim to recover the amount of the claim, if he receives the amount. This however will not be so in a case where the taxpayer at no stage asserts a claim to retain the amount and holds himself ready to return it. If the item has been derived in accordance with this principle and the taxpayer later acknowledges that his claim was mistaken and repays the amount, he will be entitled to a deduction in the year in which he repays the amount;

(3) A deduction will be incurred in the year in which the taxpayer acknowledges that an amount is recoverable from him. If the taxpayer is mistaken and in a later year the claimant gives up his claim to recover from the taxpayer the whole or part of the amount, or repays to the taxpayer the whole or part of an amount in fact received from him, there will, to this extent, be a derivation of income by the taxpayer in that later year; and

(4) A deduction will be incurred though the taxpayer has not acknowledged that an amount is recoverable from him, if he pays the amount. If the deduction has thus been incurred and the taxpayer in a later year receives an amount repaid by the person receiving the payment, there will, to this extent, be a derivation of assessable income by the taxpayer in that later year.

11.238 These principles flow from what in the United States tax law is called the “claim of right” doctrine. The authority for principles (1) and (2) is United States v. Lewis 340 U.S. 590 at 591 (1951), a decision of the United States Supreme Court. The Supreme Court referred to a principle, stated in an earlier decision, North American Oil Consolidated v. Burnet 286 U.S. 417 at 424 (1932): “If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.” United States v. Lewis concerned a cash basis taxpayer. However, the application of the same principle to a claim to recover, in the case of an accruals basis taxpayer, is implicit in the following passages in the judgment of the court (at 592):

“Income taxes must be paid on income received (or accrued) during an annual accounting period . . . The ‘claim of right’ interpretation of tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system . . . We see no reason why the court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.”

There is a footnote to the passage quoted which reflects the court's awareness that the approach in Commonwealth-New Guinea Timbers Ltd v. Chief Collector of Taxes (1972) 72 A.T.C. 4048 is unacceptable:

“It has been suggested that it would be more ‘equitable’ to reopen [the taxpayer's
earlier] tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. Internal Revenue Code, ¶322(b)."

11.239 It was conceded by the Revenue in United States v. Lewis that the taxpayer was entitled to a deduction in the year in which he repaid the amount which, it had been adjudged, he was obliged to repay. In the case of an accruals basis taxpayer the deduction will arise in the year in which the taxpayer gives up his claim to recover or, if he has already received, the year in which he repays.

11.240 The authority for principles (3) and (4) is Baltimore Transfer Co. of Baltimore City v. Commissioner of Internal Revenue 8 T.C. [U.S.] 1 (1947), a decision of the Tax Court of the United States. The taxpayer company claimed a deduction in the 1943 year of income of an amount of unemployment tax which it acknowledged was recoverable from it by the Maryland Unemployment Compensation Board. In the following year of income the Maryland Board, following legal advice, notified the taxpayer that the amount of tax was less than the taxpayer had assumed. The decision of the court was that the amount which the taxpayer had acknowledged in the preceding year to be recoverable from it was a deduction. The difference between that amount and the amount of tax properly payable was income in the later year. In giving judgment, the Tax Court said (at 7–9):

"[The Revenue's] theory seems to be that, where there is no change in pertinent law or facts after the end of the taxable year, the true liability and that only is accruable because as a matter of law it is ascertainable. This is logically equivalent to saying that if doubt as to the correct liability hinges solely upon a question of law, the accrual must be made within the taxable year according to the ultimate resolution of that question, since the determination awaited only a pronouncement by a legal expert. Such a theoretical and totally unrealistic approach cannot survive the application of the rationale of the Security Flour Mills decision [321 U.S. 281 (1944)] and Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 [(1944)] in each of which the Supreme Court clearly indicated that a controverted obligation is not accruable until the dispute is settled, even though the question is purely one of law. The disallowances of the deductions in those cases were not based on the fact that it was ultimately concluded that as a matter of law each taxpayer had no obligation and thus there was nothing to accrue. The determinative question in each of those proceedings was, as it is here, whether the accrual was proper under sound accounting principles. . . . The Supreme Court denied in the Security Flour Mills case that events occurring in a subsequent year may be seized upon as a basis for determining the allowable deductions of an earlier period. The aim of the taxing acts is to determine true income
by annual periods, not true income ‘in the light of ultimate gain from a series of transactions over a period of years growing out of, or in some way related to an initial transaction in the taxable year’” (emphasis in original).

11.241 The decisions of the United States Supreme Court, referred to by the Tax Court, that a controverted obligation is not accruable until the dispute is settled, indicate the limits of the principles making up the claim of right doctrine. Income will be derived only when the taxpayer claims a right to recover or, though he has not claimed, he actually receives an amount and claims to retain what he has received. A deduction will be regarded as incurred only when the taxpayer acknowledges the right of another to recover from him or, though he does not acknowledge, when he actually pays an amount. It may be thought that in these aspects the principles leave an element of uncertainty which mars their convenience. But the Revenue is sufficiently protected by the obligations of disclosure imposed upon the taxpayer. If, in order to avoid or postpone a derivation of income, he asserts that he does not make a claim of right in circumstances where he is taking proceedings to recover the amount he will find it difficult to maintain his assertion. If, in order to attract a deduction, he asserts that he acknowledges that an amount is recoverable from him when in fact he is denying liability, he will equally find it difficult to maintain his assertion.

11.242 An Australian court has yet to consider facts similar to those in Commonwealth-New Guinea Timbers Ltd v. Chief Collector of Taxes [P.N.G.] (1972) 72 A.T.C. 4048. There is, it is submitted, no reason arising from the Australian authorities why the model of the American law should not be adopted in Australia. There are only two obstacles in the way of adoption by Australia of the American model. These arise in relation to the adoption of what might be called corollaries of the claim of right notion. The first of these corollaries is that where the taxpayer abandons a claim or repays an amount he incurs an allowable deduction. The second corollary is that where the claimant gives up a claim which the taxpayer had acknowledged to be legally recoverable from him, or repays an amount paid to him by the taxpayer, there is an item of assessable income. The obstacle in relation to the first corollary is in the terms of s. 63 of the Assessment Act, which allows a write-off of a bad debt. The requirement that the amount has been brought to account as assessable income is satisfied, but it may be that the word “debt” is to be construed as referable only to an amount which is legally recoverable. This was the view of the Papua New Guinea Supreme Court in Commonwealth-New Guinea Timbers and it is a view which may be thought to have been settled as correct by the decisions in Point (1970) 119 C.L.R. 453 and G. E. Crane
Sales Pty Ltd (1971) 126 C.L.R. 177. It should be noted, however, that Point can be explained on the basis that the taxpayer could not write off a claim which he had ceased to assert and that G. E. Crane Sales can be explained on the basis that the taxpayer could not write off a claim which it had assigned to another. In any case, the fact that the corollary cannot operate through the terms of s. 63 does not mean that it cannot operate through s. 51. Once it is accepted that the claim to recover was a derivation of assessable income the reasoning of the Papua New Guinea Supreme Court against the deduction under the equivalent in the New Guinea Income Tax Ordinance of s. 51(1) has no application.

11.243 The obstacle to the operation of the second corollary might be thought to be the decision of the High Court in H. R. Sinclair & Son Pty Ltd (1966) 114 C.L.R. 537. In that case the High Court denied that there was any general principle that the receipt of a repayment of an amount which had been allowed as a deduction in an earlier year must necessarily be income. None the less it held that the repayment to the taxpayer in the case was assessable income as a trade receipt. In so holding, the High Court took the view that the amounts which had been paid by the taxpayer had been properly paid in the sense that they were amounts which were legally recoverable from him. It might be thought that the court thus raised a suggestion that there is a distinction to be drawn between the repayment of an amount which had been properly paid and the repayment of an amount which had been wrongly paid. The denial of a general principle may be unfortunate in other contexts, but the principle that a trade receipt is income will be sufficient in the context of deductions to which accruals tax accounting applies. The suggestion that some distinct principle might apply to the return of an amount wrongly paid is unfortunate. It lets in issues of general law and fact going to whether an amount was “legally payable”—the phrase is used by Taylor J. in Sinclair (at 543)—which, it is submitted, should have no place in tax accounting. Any such suggestion is hard to explain having regard to the awareness shown, at least by Taylor J., of the very limited powers of reopening assessments given by the Assessment Act.

The Treatment of Interest, Premiums and Discounts on Loans

11.244 Interest may be distinguished from the amount of a premium which a borrower may be required to pay to the lender on the repayment of a loan. The word premium in this context will generally be used to describe an amount which the borrower agrees to pay on repayment of the loan in excess of an amount expressed by the loan agreement to have been lent to
him, and in fact lent to him. Its function is indistinguishable from an amount by which the amount that a borrower acknowledges he is bound to pay to the lender exceeds the amount in fact lent to the borrower. In the latter circumstances, it would be said that an acknowledgement of a debt has been originally issued at a discount, “discount” referring to the amount by which the amount the borrower is obliged to pay to discharge his indebtedness exceeds the amount he received in exchange for his acknowledgement. Both premium and discount are illustrated in the facts of *Lomax v. Peter Dixon & Son* [1943] K.B. 671.

11.245 Interest identifies a payment for the use of money by reference to the period of use of that money. This meaning is reflected in the expression of a rate of interest as a percentage of the amount lent, payable for a specified period of use. It is also reflected in the statement of principle that, in the absence of a contrary provision, “interest accrues from day to day”. “Accrues” in this statement may have a meaning different from its meaning when it is said that a receipt has accrued, or an outgoing has accrued, and is thus derived by or incurred by a taxpayer on an accruals basis of tax accounting in relation to the item.

11.246 The fact that an item is correctly described as interest, a premium or a discount, will not necessarily provide an answer to the question whether the item has the character of income or the character of deductibility. Where the issue is income character, the question will be whether the item is a gain derived from property. Where the issue is deductibility the question will be whether it is a relevant and working expense of some process of income derivation. If an item is correctly described as a premium, it may yet be income as a gain derived from property of the lender: it is likely to be such if, though payable only on the termination of the lending, its amount will abate by reference to the period of time the loan has been on foot and in such circumstances a claim by the borrower to a deduction of the premium as a payment for the use of property used in a process of income derivation may be open. That a premium or discount may be income of the lender in other circumstances as a gain derived from property will be apparent from the discussion of principle by Lord Greene M.R. in *Lomax v. Peter Dixon*, considered in [2.285]ff. above.

11.247 A premium or discount that is not income as a gain derived from property, may yet be income as a profit on the realisation of a revenue asset. The character of the lending as being on revenue account or on capital account is not relevant when the issue is whether the item derived is income as a gain derived from property. Whether the lending is on revenue account or on capital account becomes critical if the question is whether the premium is income as a profit on realisation of an asset. A premium or
discount may be a deductible loss by the borrower where the liability
arising from his borrowing is on revenue account.

Accounting for interest

11.248 Generally, interest will be accounted for on a cash basis. In some
circumstances, however, interest will be accounted for on an accruals
basis—where, for example, it is derived by a bank from loans made in the
ordinary course of its business.

11.249 Accounting for interest on a cash basis will follow principles
considered in [11.122]–[11.136] above. There are questions as to the scope
of s. 19, and as to the scope of a principle of constructive receipt, for
example where interest is “capitalised” or interest presently receivable is
assigned to another. These questions, where an interest receipt presently
receivable is assigned to another, are discussed below in Chapter 13. The
outcome of that discussion is that the effect of the assignment on interest
that is presently receivable by a lender is a receipt by the lender if he is on
a cash basis in relation to the item, and there is a derivation by him. It will
follow that there is no derivation of interest by a lender who has assigned a
debt and with it the right to interest, if the interest becomes presently
receivable subsequent to the assignment. Nor is there a derivation of
interest by a lender if he assigns a right to future interest—the loan being
one that gives rise to a right to future interest as distinct from
expectancies—if interest becomes presently receivable subsequent to the
assignment. The interest will be derived by the assignee. The assignment
does not give rise to any constructive receipt by the assignor. In some
circumstances interest will have to be accounted for on an accruals basis.
A.T.C. 6001 at 6034, and in National Commercial Banking Corp. of Aust.
Ltd (1983) 83 A.T.C. 4715 is that interest is derived by a taxpayer on an
accruals basis in relation to the interest, when it becomes presently
receivable by him, and thus on the lapse of each time period for which it is
receivable.

11.250 Accounting on a cash basis for incurring of outgoings for interest
raises issues parallel with those raised in regard to derivation. The view has
been taken in this Volume that there is a notion of cash accounting
applicable to outgoings, and that this notion will be attracted whenever
receipts by the taxpayer in the same process of income derivation would be
accounted for on a cash basis. It is true that accounting for outgoings has
been considered in the authorities, more especially in James Flood Pty Ltd
144 C.L.R. 616 as if no distinction between a cash basis and an accruals basis is to be drawn. But the authorities all involve circumstances where accounting for related receipts would be on an accruals basis. In [11.174]–[11.180] above, principles of cash accounting in relation to the incurring of outgoings are discussed, and the possibility of a principle of constructive payment explored. These principles will be applicable to accounting for interest outgoings.

11.251 Where a taxpayer is on an accruals basis in regard to outgoings of interest, the principles in *James Flood* and *Nilsen* govern. But their application gives rise to special problems. The notion of an accrual that will be an outgoing incurred is not always the converse of an accrual that will be derivation of an item. The possibility is raised by the statements of principle in *James Flood* that an item may be deductible notwithstanding that it will not become presently payable until some later time and that it involves a defeasible liability. Interest income, it is assumed, will not be derived by a lender on an accruals basis until the time has run in respect of which interest is payable and the interest is presently receivable. Interest, it seems, can be prima facie an outgoing incurred even though the time in respect of which the interest is payable has not yet run and the liability to pay is defeasible. The matter is discussed in [11.119] above. A principle that an outgoing is incurred only as the benefit arising from it is consumed, will, however, defer deductibility of the interest outgoing so that it is deductible only as the period of the loan to which it relates elapses. The authorities are *Alliance Holdings Ltd* (1981) 81 A.T.C. 4637 and *Australian Guarantee Corp. Ltd* (1984) 84 A.T.C. 4642.

**Accounting for premiums and discounts**

**In relation to the lender**

11.252 The meaning of the words “premium” and “discount” are explained in [11.244] above. The present concern is with the possible application of receipts and outgoings tax accounting, where the item is a premium or discount. The possible treatment of a premium or discount as income in the form of a profit on the realisation of an asset is considered in [12.183]-[12.184] below.

11.253 In some circumstances it is possible to regard a premium received or a discount allowed in relation to a loan, as income derived from property. The matter was discussed in connection with *Lomax v. Peter Dixon & Son* [1943] K.B. 671 in [2.285]ff. above. Where the loan does not provide for interest or provides for interest at less than the prevailing commercial rate, the conclusion may be drawn that a premium receivable...
on repayment of the loan, or the difference between the amount of the loan and the amount in fact paid to the borrower when the loan moneys were paid to him, is a gain to the lender derived from property and income on this basis. The conclusion will not be drawn in relation to an amount that can be said to be “for the capital risk” the lender experienced in making the loan. “Capital risk” includes the possibility of a fall in the purchasing power of the currency in which the loan was made. So far as the premium or discount does recoup a fall that has in fact occurred, it is in substance a return of the money lent and not a gain derived from the money lent. This recognition of a consequence of inflation is some concession by income tax law to a reality which has otherwise been steadfastly excluded from consideration in the judicial development of the law.

11.254 The treatment of a premium as income derived from property will be more likely if its amount is related by the loan agreement to the period the loan has been on foot. If a rebate of the premium is available to the borrower on early repayment of the loan, a conclusion that the premium is a payment to him for the use of the money lent is more easily drawn.

11.255 *Lomax v. Peter Dixon* is not concerned with the time of derivation of a premium or discount held to be income as a gain derived from property. If the taxpayer is on a cash basis in relation to the item, the time of derivation must be the time of repayment of the loan. Where he is on accruals, the time of derivation is presumably when the loan becomes repayable. *Willingale v. International Commercial Bank Ltd* [1978] A.C. 834 may be authority, though the approach in that case appears to have been in terms of a profit realised that was income.

In relation to an assignee from the lender

11.256 Characterisation of a premium or an amount of original issue discount as income derived from property becomes near impossible where there has been an assignment of the debt owed by the borrower. And the tax accounting problems are unmanageable.

11.257 The original lender who has assigned will not receive and will have ceased to be entitled to receive the payment which will include the premium or discount. There may be some basis for treating the premium or discount as derived by him in some part referable to the period he held the debt, and for treating it as income in the form of a gain derived from his holding of the debt for this period. But such an approach would be confronted by the circumstance that the taxpayer may not in fact receive the amounts treated as having been derived by him. The amount he receives on assignment will not necessarily reflect the amount of the
premium or discount referable to the period he held the debt. Indeed the prospect that there could be an assignment with these attendant problems may be good reason to put out of consideration generally any idea of treating a premium or discount as being income derived from property.

11.258 The difficulties of characterisation and of tax accounting are no less when the treatment of the assignee is in question, even if that assignee in fact holds until the loan is repaid. The element of any discount will be reflected not in what the assignee paid for the debt, but what was paid for it on original issue. An assignee will not know what was originally paid for the debt.

In relation to the borrower

11.259 The question in relation to the borrower is whether the amount of original issue discount, or premium payable on repayment, may be treated as an outgoing for the use of the money borrowed. There may be reason to treat a premium in this way where the premium abates on early repayment of the borrowing, or where the amount of interest payable is less than a commercial rate. And there may be reason to treat it as a payment for use in other circumstances. There is, however, no principle that the character of the outgoing by the borrower must match a character of income derived from property in the hands of the lender. Deduction by the borrower must in any event depend on the satisfaction of a test of relevance which will look to the use of the money borrowed in a process of income derivation, an aspect of the transaction obviously irrelevant in determining the character of the receipt in the hands of the lender.

11.260 Section 67 proceeds on a view that some expenses in relation to a borrowing are not outgoings incurred for the use of the money borrowed. A special regime of deductibility is applied to those expenses. The scope of s. 67 and its relationship to s. 51(1) were the subject of some consideration in Ure (1981) 81 A.T.C. 4100 and were discussed in [10.217]ff. above.

11.261 Whether the outgoing is one that will be paid to the lender, or to a person who has succeeded to the rights of the lender, a characterisation of the outgoing as a payment for the use might be appropriate, even when a characterisation of the receipt by the lender as a receipt for the capital risk in lending is appropriate. But treating a payment to recoup the lender for any loss he may incur as a result of a fall in the value of money lent, as a payment for the use of the money, is at least difficult. The economic significance of a payment to recoup a fall in value is a repayment of the loan. A payment so regarded is not a payment for use.

11.262 If a discount or premium is seen as a payment for the use of money
and a deductible outgoing under s. 51(1), there will be a question of when the outgoing is incurred. If *Alliance Holdings Ltd* (1981) 81 A.T.C. 4637 and *Australian Guarantee Corp.* (1984) 84 A.T.C. 4062 are followed, an outgoing for interest, unless the liability is only contingent, will be deductible by an accruals basis taxpayer as the period of the loan in relation to which the interest payable elapses ([11.250]-[11.251] above).  

**11.263** If a discount or premium is not seen as a payment for the use of money, it will not be deductible as an outgoing. The borrower will need to establish a loss expense on the discharge of his liability. Deductibility will require a finding that the liability was on revenue account, which is a different notion from liability to repay in a process of income derivation. Deductibility on this basis is considered in [12.185]-[12.186] below.

**The Treatment of Discounts on the Negotiation of Bills of Exchange**

**11.264** Difficult questions of analysis arise if it is sought to explain a transaction involving a bill of exchange as a lending of money, or as one that gives rise to a relationship of debtor and creditor between parties to the bill. Those questions of analysis cannot be avoided if the issue is whether a party to a bill of exchange has derived “interest”, or has paid “interest”. Such issues are posed in the operation of withholding tax, a subject outside the scope of this Volume. The questions of analysis do not arise where the issue is simply whether the taxpayer has derived income, or has incurred a deductible outgoing.

**11.265** A person who discounts a bill will be entitled on maturity to a payment greater than the amount he paid for the bill. Whether this greater amount is his income as a gain derived from his property—the obligations evidenced by the bill—is a question no different from that which arises when a taxpayer acquires a debt at a discount, a matter considered in [11.252]-[11.258] above. A taxpayer who is the drawer may negotiate a bill at a discount, and come under a liability to pay a greater amount on maturity as a party liable on the bill than the amount he received on negotiation. Whether he incurs a deductible outgoing depends on the possible characterisation of the discount as an expense for the use of money which he has outlaid in a process of derivation of income. It is no different from the question already considered in regard to a person who receives an amount as a loan in exchange for an obligation to repay a greater amount ([11.259]-[11.263] above).

**11.266** A transaction involving a bill of exchange may, of course, involve relationships which do not correspond with relationships involved in the
lending and borrowing of money, and the assignment of a debt for money lent. Where those relationships are involved the issue of derivation of income and the incurring of a deductible outgoing need to be resolved on other principles. Thus a bank which receives a fee for providing a service in accepting a bill of exchange as an accommodation party, derives the fee as income but not in the character of a gain derived from property. If on payment of the bill on maturity it does not receive equivalent funds from the party accommodated, it suffers a loss that is deductible. It is a loss in relation to the discharge of an obligation that is a liability on revenue account. Clearly it does not incur an outgoing that is an expense for the use of money.

11.267 The possibilities of a party to a bill of exchange deriving income in the nature of a profit on the realisation of an asset, incurring a deduction in the nature of a loss on such realisation, or deriving income or incurring a loss on the discharge of a liability are further considered in [12.217]-[12.219] below.

Accounting for Royalties and Income Derived from Property

11.268 Attention was given in [2.309]ff. and [4.114]ff. above to items that are income either as royalties within the meaning of the word in s. 26(f) unaided by the definition in s. 6, and items that might be called royalties but are income only as items that are within the ordinary usage meaning of income as gains derived from property. Generally all these items are income in their gross amount, not as specific profits when the income element would be a part only of the gross amount. Where the item is income in its gross amount there will, at least in some circumstances, be an apparent offence to the principle that income involves a gain. In what follows, an attempt is made to identify the occasions when there is risk that accounting for income derived from property will result in the taxing of items that are not wholly gains. The possibility of applying specific profit accounting in such circumstances is raised, and the corrections that result from the operation of depreciation and amortisation provisions are noted.

11.269 It is necessary, more particularly to enable a consideration of the role of the depreciation and amortisation provisions, to distinguish circumstances in which some proprietary rights remain with the taxpayer and circumstances in which all proprietary rights have been transferred. And it is necessary to draw a number of other distinctions.

Where general property rights remain with the taxpayer
A distinction may be drawn between circumstances where property is physically depleted by use, and circumstances in which it is not.

Property physically depleted by use

Excluding for a moment the fact that timber is a renewing resource, *McCauley* (1944) 69 C.L.R. 235 is an affront to a principle that income is a gain. The taxpayer was simply unfortunate in the means he adopted by which to realise his property in timber standing on his land. There was no gain in the realisation of the timber unless the receipt by the taxpayer exceeded, in regard to any taking, the market value of the timber before that taking, or, perhaps, the market value at the time the taxpayer entered into the arrangement under which the timber was taken.

Certainly where the physical property taken in a *McCauley* royalty situation is not a renewing resource—it is blue metal, gravel or sand—there is an affront to the principle. Where the physical property is timber, it is arguable that timber as it grows is already a gain derived from property that will be realised on disposition of the timber, whatever the form the disposition takes—though the point was not taken in *Stanton* (1955) 92 C.L.R. 630. This argument would justify the result in *McCauley*, save so far as the timber taken had grown before the taxpayer acquired the land. And it affords a justification for the express provison in s. 124J by which, in *McCauley* circumstances, a deduction may be allowed for an appropriate part of the cost of the timber at the time the land with growing timber was acquired. Section 124J is considered in [6.184], [6.198-9], [7.19], [7.28], [7.54], [11.271] above and [12.82] below.

Property not physically depleted by use

Where the property is not physically depleted by use, and its value does not decline by use or by effluxion of time, a receipt that is a gain derived from the property may be seen as pure gain. An illustration would be a receipt in respect of non-exclusive licence to use a trade mark.

There is, however, at least a theoretical difficulty in treating the receipt as a pure gain when exclusive rights to use are given. It could be said that there has been a partial realisation of property: there is no gain derived from the property. The distinction between a receipt that is a premium on the grant of exclusive rights to use and a receipt that is a payment for use is perhaps beyond drawing except in the terms of form factors: periodicity and a provision for abatement if the period of the exclusive licence does not run its course have been relied on.

If the law were to allow a deduction against receipts in respect of
property not physically depleted by use whose value does not decline as a result of use or by effluxion of time, so as to relieve from tax that element of the receipts that is not a gain, the fixing of the amount of the deduction could not avoid being arbitrary.

11.276 Where the property is not depleted by use but its value declines as a result of use, the depreciation provisions of the Assessment Act seek to keep faith with the principle that income is a gain. Those provisions are considered in [10.130]ff. above. The amount of the deduction is fixed by the provisions and is to a degree arbitrary. Where the property is not depleted by use, but its value declines by effluxion of time, the amortisation provisions of Div. 10B of Pt III seek to keep faith with the principle that income is a gain. Division 10B is considered in [10.239]ff. above. The amount of the deduction is fixed by those provisions. The deduction is related to the life of the asset and the effluxion of time. In [10.241] and [10.261] above, attention is drawn to an argument that Div. 10B has no application where a licence is given in exchange for receipts that are income as royalties or gains derived from property. If the Division does not extend to such a situation, it fails to a degree to keep faith with the principle that income is a gain.

Where general property rights are disposed of

11.277 It would seem that there may be income derived from property where the form of receipts for the use of property is satisfied, notwithstanding that there has been an outright disposition of the property. The matter is considered in [2.332]ff. above. In this instance there are no statutory provisions that would keep faith with the principle that income is a gain. Both the depreciation provisions and the amortisation provisions are available only where the taxpayer is a continuing “owner”. The suggestion is made by Barwick C.J. in *Cliffs International Inc. (1979) 142 C.L.R. 140* at 150-151 that the receipts by Howmet Corp. and Mt Enid Ltd were income of those companies, presumably as royalties or income derived from property. The protection of the principle that income is a gain would require a deduction of so much of the value of the shares held by those companies in the company that owned the mining rights as had not been recouped by the lump sum receipt. The deduction would be spread over the period of possible receipts arising from the exercise by Cliffs International of the mining rights, or perhaps spread by reference to a measure of the exercise by Cliffs International of those mining rights.

Accounting for royalties and income derived from property on an accruals basis
Attention has been directed in [11.250] above to the possibility that for some taxpayers interest may have to be accounted for on an accruals basis. The New Zealand decision in \textit{C.I.R. (N.Z.) v. National Bank of N.Z.} (1977) 77 A.T.C. 6001, 6034 would appear to have been accepted in Australia (\textit{National Commercial Banking Corp. of Aust. Ltd} (1983) 83 A.T.C. 4715). It was assumed in \textit{Aktiebolaget Volvo} (1978) 78 A.T.C. 4316 that the receipts in respect of the keep-out covenant entered into by Volvo Sweden, if they were income, would be accounted for on an accruals basis.

The assumption in \textit{Volvo} led, in the view of Jenkinson J., to some strange consequences flowing from the drafting of the definition of royalty in s. 6, and the provisions of s. 6C which at the time gave an Australian source to royalties (as defined), when they were paid by a resident to a non-resident. If Jenkinson J. had concluded that the receipts by Volvo Sweden from Volvo Australia were royalties and were of an income nature, he would none the less have held that they were not assessable income of Volvo Sweden—a non-resident—because at the time of their derivation by Volvo Sweden they did not as yet have an Australian source. The receipts were derived when they became payable by Volvo Australia to Volvo Sweden: they were to be accounted for on an accruals basis. But they did not acquire an Australian source until the following year, when they were actually paid to Volvo Sweden.

The view expressed by Jenkinson J. involves an extension of the principle that the income character of an item must be judged at the time of derivation. As extended, the principle also requires that the source of an item must be judged at the time of its derivation, which in the \textit{Volvo} circumstances was the time when the amounts became receivable by Volvo Sweden. The effect of s. 6C was to give an Australian source only to an amount paid. Payment did not occur until the next following year of income. The amounts derived by Volvo Sweden could not therefore have an Australian source at the time of derivation. The analysis requires a conclusion that there could not have been a derivation of assessable income by Volvo Sweden, even though the payment had been made immediately after the amount became payable. At the instant of derivation, an Australian source would still be lacking.

The implications of the view taken by Jenkinson J. might have been avoided by interpreting s. 6C so that it gave an Australian source retrospectively. In fact s. 6C, and the definition of royalty in s. 6, were amended shortly after the \textit{Volvo} decision so as to add the words “or credited” after the word “paid”. It may be that the amendment shows an intention that would preclude a retrospective operation, and to confirm the
analysis of Jenkinson J. In which event, the adequacy of the amendment becomes critical. It will appear from the discussion in [11.46] above that an amount may be derived by an accruals basis taxpayer without any “crediting” by the person from whom an amount is receivable. Crediting—presumably an entry in the books of the person from whom the amount is receivable—may be a step in a constructive receipt by a cash basis taxpayer. But it is irrelevant to a receipt by a taxpayer on an accruals basis in relation to the item. The possibility therefore remains that an item may escape inclusion in assessable income because it is derived before it acquires an Australian source.

Accounting for annuities and periodical receipts

11.282 It would be assumed that receipts that are income as annuity receipts or under the periodical receipts principle will be accounted for on a cash basis. The receipts do not admit of characterisation as business receipts.

11.283 Attention has been drawn in [2.209] and [2.215]ff. above to the prospect that annuity receipts and other periodical receipts may be income in their gross amounts even when they have been purchased, and the resulting defeat of the principle that income is a gain. There are provisions in s. 27H (formerly s. 26AA) in regard to annuity receipts—which may be a more limited category of receipts than those that are the subject of the ordinary usage periodical receipts principle—which preserve the principle that income is a gain by excluding from income a part of each receipt as reflecting the purchase price. Those provisions may not be effective in all circumstances. The discussion in [2.220]–[2.221] above of *Just* (1949) 8 A.T.D. 419 and *Egerton-Warburton* (1934) 51 C.L.R. 568 is relevant. And they will not apply where the relevant receipts are not annuity receipts or a superannuation pension, though they are within the ordinary usage periodical receipts principle. There is room for a judicial development of the law that will apply profit accounting to annuity and periodical receipts by excluding from income so much of each receipt as may be seen as proceeds of an outlay to acquire the right to that receipt. The identification of the outlay, and its valuation, will no doubt present problems. But the problems ought not to be any less soluble than the problems of determining cost which the High Court assumed in *Whittfords Beach Pty Ltd* (1982) 150 C.L.R. 355 required solution. There is a line of argument that would say that the express provisions in s. 27H excluding amounts reflecting the purchase price, have covered the field and leave no room for judicially established principles. However appropriate the expressio unius rule of
interpretation may be in the interpretation of other statutes, it has limited appropriateness in a taxing statute, and none where it will exclude a principle that is vital to the integrity of the tax.

Correlation of Accounting for Receipt and Accounting for a Deduction by the Payer

11.284 Attention has been directed in a number of places in this Volume to the absence of any general principle which might have asserted that a payment received acquires income character from the deductibility of the payment by the payer, and that a payment made acquires a character of deductibility from the income character of the receipt of the payment in the hands of the payee. Thus there is no principle which would assert a necessary correlation between the character of a receipt by the taxpayer in a situation as in *Dickenson* (1958) 98 C.L.R. 460 and deductibility by the oil company making the payment.

11.285 Equally there is no principle that would assert a necessary correlation between the method of accounting for a receipt that is income, and the method of accounting for the payment of it where the payment is deductible. Thus a taxpayer may be on cash in regard to the amount of a receipt of income and the person who pays that amount may be on accruals in regard to deductibility. The common situation will be a taxpayer receiving interest accounted for on a cash basis, and a taxpayer paying interest accounted for on an accruals basis. It will follow that the moment of accounting for the income receipt will differ from the moment of accounting for the deduction, and both may not occur in the same year of income. A taxpayer may derive an amount of income accounted for on an accruals basis, and another may be entitled to an allowable deduction accounted for on an accruals basis in relation to the payment of that amount. In that situation there may be a radical want of correlation arising from the decision in *Australian Guarantee Corp. Ltd* (1984) 84 A.T.C. 4642. The payee of interest will account, even though he is on an accruals basis, no sooner than the time when interest becomes presently receivable by him. The payer will be entitled to deduct when he comes under a liability to pay interest, though payment is, by the loan agreement, deferred till the time of repayment of the loan. The want of correlation is mitigated only by the fact that deductibility is spread over the period of the loan.

11.286 Even though, in a particular case, the moment of derivation of an amount by a taxpayer accounting on an accruals basis, and the moment of incurring of the related outgoing by another taxpayer accounting on an accruals basis are the same in all other respects, there will remain the
prospect of a want of correlation arising from the application of the principle in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314 in regard to derivation, and the possible absence of any corresponding principle in regard to outgoings. Australian *Guarantee Corp. Ltd* suggests a principle that would be the converse of *Arthur Murray* applied to outgoings, though the Federal Court may not have intended to assert a general principle. There is nothing in the judgment to indicate that the court was aware of the significance of their decision for general principles of tax accounting. An item otherwise derived will be brought to account over the period during which it is earned in accordance with the principle in *Arthur Murray*, but the related outgoings otherwise incurred may be deductible immediately, notwithstanding that the benefit arising from that outgoing will be consumed over a period. The common illustration is a company that is now entitled to receive an amount in respect of management services that it promises to perform in the future. It will account for this amount over the period during which it will provide the services. The company that is liable to pay now for the services it will receive is, it seems, entitled to deduct the amount of the payment now. The matter is discussed in [11.116]–[11.121] above.

11.287 The Commissioner may feel that it is in all circumstances unfair that no income is derived by the taxpayer receiving when another taxpayer who is liable to pay or does pay is entitled to a deduction. But there is certainly no principle or specific provision that would support the Commissioner's point of view.

11.288 The Commissioner may be content to assert a more limited point of view that would claim unfairness where the derivation and incurring involve a transaction between associated taxpayers. Two kinds of situation may be distinguished:

(i) One taxpayer incurs an outgoing that is deductible, but the related receipt will not at any time be income of the associated taxpayer who receives. In language adopted above in the context of assignment of income situations, there may be said to be an income swallow. The taxpayer incurring the outgoing insulates from tax an equivalent amount of its income. There is no income of the like amount derived by the associated taxpayer. An illustration is a payment for a tie made by an oil company to a subsidiary company. The company that pays claims the application of *B.P. Australia Ltd* (1965) 112 C.L.R. 386. The company receiving claims the application of *Dickenson* (1958) 98 C.L.R. 460. The Commissioner may find support for his view that this outcome is unfair in the general anti-avoidance provisions of the Assessment Act contained in Pt IVA. The view of this Volume is that he does not need the support of Pt IVA. It is already available in the terms of s. 51(1): where the parties are associated, an objective inference that the outgoing was
not incurred for the purpose of deriving income is open.

(ii) One taxpayer incurs an outgoing that is presently deductible but the related receipt by the associated taxpayer will not, wholly or in some part, be income derived until a later year of income. If one considers together the interests of the associated taxpayers, there is in effect a deferral of tax on income that for the time being is insulated from tax by the incurring of the outgoing. In this situation the Commissioner is given support by the specific provisions of s. 82KK.

11.289 Section 82KK deals specially with interest that may be deductible by one taxpayer, who is on an accruals basis, when liability to pay arises, and subject to withholding tax in the hands of a taxpayer who is an associate, only when paid to him. “Associate” is defined in a comprehensive manner in s. 82KH(1). The effect of s. 82KK is to defer the deduction until interest is actually paid so that deduction and derivation of income occur in the same year.

11.290 For the rest, s. 82KK draws a distinction between situations involving the supply of goods or services and other situations. The supply of goods or services is assumed to be the only kind of situation to which the principle in Arthur Murray will apply. The effect of s. 82KK(3) is to defer the deduction of outgoings to an associate for goods or services to the years in which the goods or services to which the outgoings relate are supplied or provided. The manner of the deferral is more specifically provided for in s. 82KK(4).

11.291 In other situations, s. 82KK(2) deems an outgoing to an associate to have been incurred in the year of income or in a subsequent year of income only to the extent to which it represents an amount actually paid in that year of income. The assumption is that the amount will be income of the associate receiving payment in the year of income in which it is paid to him. That assumption will be correct only if receipts for goods or services are the only situations in which the Arthur Murray principle is applicable. In [11.111]–[11.112] above it was suggested that the principle, or a wider principle, is applicable to passive income, for example rent or interest received in advance. If it is applicable, s. 82KK is deficient. An actual payment of interest between associated persons will, it seems, be deductible when it is paid, notwithstanding that the interest received will be income derived over the period of lending to which the interest received relates.

11.292 In all its applications s. 82KK is confined by s. 82KK(2)(b) to circumstances where the outgoing was incurred “by reason of, as a result of, as part of or in connection with an agreement, course of conduct or course of business that was entered into or carried out for the purpose, or for purposes that included the purpose, of securing that . . . [the receipt by
the associated person] would not be included in [his] income . . . until a subsequent year of income.” It may be doubted whether s. 82KK should thus be confined in its application. It is argued in [16.41]–[16.42] below that provisions of the Assessment Act which depend for an application on a finding of what is referred to as a tax avoidance purpose, are undesirable and unnecessary. Provisions which are directed to denying a tax advantage only when it may be inferred that a party to a transaction entered the transaction wanting the tax advantage that it gave, reflect a most curious approach: a taxpayer may have a tax advantage, provided it cannot be inferred from his actions that he wanted the advantage. If it is thought unacceptable that tax advantages may attend transactions between associated taxpayers, it is appropriate to deny them in all such transactions. At the same time there is good reason to question the principles from which the tax advantages arise. There is a tax advantage to be gained from any transaction, whether or not entered into with an associated person, that will allow a current deduction of an outgoing that is otherwise incurred in advance of the provision of goods or services, or the use of property of another, that is obtained by the outgoing. That advantage will be denied if a principle is adopted that will treat such an advance payment as deductible only as it is consumed in the sense explained in [11.116]–[11.119] above. There is a tax advantage that is to be gained by any taxpayer who is on a cash basis in relation to an item if actual receipt by him is delayed. There is reason to adopt accruals as the basis in relation to items of interest, rent and royalties, whenever they are derived in relation to business operations, which would include the lending of money to an associated company. The assumption of Jenkinson J. in Aktiebolaget Volvo (1978) 78 A.T.C. 4316 that Volvo Sweden was on an accruals basis in relation to the royalty receipts may point the way.
Chapter 12: Accounting for Specific Profit or Loss

Introduction

12.1 The distinction between two regimes of tax accounting, the first identified as receipts and outgoings accounting and the second as specific profit or loss accounting, was drawn in [11.7]ff. above. Specific profit or loss accounting is different from the financial accounting that might be called overall profit or loss accounting. Overall profit or loss financial accounting is the process of determining the positive or negative balance of the profit or loss account for an accounting period. The parallel in tax accounting is the process by which allowable deductions (which may be outgoings or specific losses) are subtracted from assessable income (which may be receipts or specific profits) to bring out a figure of taxable income for the tax accounting period identified as a year of income.

12.2 Receipts and outgoings tax accounting is the generally appropriate method of accounting where the taxpayer is engaged in a continuing business. Some transactions of a continuing business will however call for specific profit or loss accounting. It is explained in [11.7]-[11.11] above that the cost of a non-wasting revenue asset is not an outgoing, and the item of gain or loss that may be assessable income or an allowable loss is the positive or negative balance of proceeds of realisation of the asset over that cost. At least this is so where the Assessment Act has not provided that the cost is an outgoing and the proceeds are income. It has done so in regard to trading stock of a business, though with some confusion of analysis. There is an express provision in s. 51(2) intended to allow the deduction under s. 51(1) of the cost of trading stock and it is an appropriate inference that proceeds of realisation are income in the whole of their amount. The effect of the trading stock provisions is to force accounting for trading stock into a special framework of receipts and outgoings accounting, which brings about tax consequences which generally accord with specific profit or loss accounting, though there are important differences. Those differences are mentioned at appropriate points in the present discussion of specific profit or loss accounting, and are developed in more detail later in Chapter 14 below.

12.3 Not all revenue assets of a continuing business are trading stock, and in regard to assets that are not trading stock specific profit or loss accounting is the appropriate regime. Thus, for example, the regime applies in accounting for the transactions in securities of a taxpayer engaged in a continuing business of the kind found by Gibbs J. to exist in *London
Australia Investment Co. Ltd (1977) 138 C.L.R. 106; for the transactions in securities of a bank or life insurance company; and for the transactions in loans of money entered into by a money lender. And the regime applies to exchange gains and losses on revenue account experienced by a taxpayer. In this instance, the regime extends both to revenue assets and to liabilities on revenue account.

12.4 Where the taxpayer enters upon an isolated business venture—in the sense of those words when used to identify an aspect of the ordinary usage meaning of income—specific profit or loss accounting will be the appropriate regime. The line that separates a continuing business from an isolated business venture is not definitively drawn. Some want of definitiveness is inescapable. St Hubert's Island Pty Ltd (1978) 138 C.L.R. 210 may be seen as holding that the taxpayer company was engaged in a continuing business of land development and sale. At least in the implications of the matters treated as common ground by the parties in Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355, the taxpayer company in that case was engaged in an isolated business venture. Yet the line of distinction between the facts of the cases is not very evident.

12.5 Specific profit or loss accounting is the appropriate regime where a transaction or venture is entered into that may give rise to a profit or loss under either limb of s. 25A(1) (formerly s. 26(a)) or under s. 26AAA. In these instances the accounting will reflect the specific statutory provisions, and the interpretations given to those provisions by the courts.

12.6 The notion of an isolated business venture suggests a venture which has no affinity with any other ventures in which the taxpayer is currently engaged, in which he has engaged in the past, or in which he will engage in the future. If there is such affinity, ventures each of which would be a distinct business venture if it stood alone, may become aspects of a continuing business to which the generally applicable regime is receipts and outgoings. An illustration may be afforded by the activities of a building contractor. The consequence will be that some expenses will be deductible currently, as buildings are being completed. But the possibility is not excluded that profit or loss accounting may be applicable to each building venture.

12.7 The assumption in previous paragraphs has been that receipts and outgoings accounting is appropriate only to a continuing business, and that it is not appropriate to an isolated business venture. There will be occasions when receipts and outgoings accounting may offer a more correct reflex of the income of an isolated business venture than profit or loss accounting. The application of receipts and outgoings in these circumstances may be justified as giving the better reflex, in the same way as a choice between
accruals and cash accounting, within receipts and outgoings, may be justified. In the circumstances of *New Zealand Flax Investments Ltd* (1938) 61 C.L.R. 179 receipts and outgoings accounting, tempered in relation to receipts by the principle in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314, may give a more correct reflex of income than would be afforded by profit or loss accounting, which would, presumably, have deferred any recognition of income until the completion of the development stage in the farming of the flax.

**Specific profit accounting within receipts and outgoings accounting of a continuing business**

12.8 Generally, specific profit accounting within a continuing business will relate to revenue assets that are not trading stock. The costs of acquiring such assets, if they are not wasting, are not outgoings. They are mere outlays, and not deductible under s. 51(1). The costs, none the less, enter the calculation of a profit derived that is income, or of a loss that is deductible. There is a question of what outlays are to be treated as such costs. There will be a derivation of the profit that is income or an incurring of the loss that is deductible at the moment or moments when the specific profit or loss is to be struck. There is a question as to the identification of that moment or those moments.

12.9 The question of what outlays are to be treated as costs is parallel with the question of what deemed outgoings in respect of trading stock—the deeming arises from s. 51(2)—are to be treated as costs of trading stock. Unless the taxpayer has elected another basis of valuation of the relevant items of stock, the deduction of costs of trading stock that are on hand at year end will be deferred until the year of income in which the stock is disposed of, so that there is, in effect, an accounting for profit. It will be seen in Chapter 14 below that the costs of trading stock of a manufacturer include not only direct costs but also a share of on-costs—the overheads of a business. There are problems, though less acute, in determining the costs of the trading stock of a merchant. The treatment of costs of storage of trading stock may pose such a problem.

12.10 Revenue assets that are not trading stock will generally be choses in action, for example the investments in the circumstances of *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106, and one might expect outlays that are to be treated as costs to be limited to direct costs.

12.11 The matter of identifying the moment or moments when a profit must be struck is not so easily resolved. In the case of trading stock, what is in effect a profit is struck at one moment—when the item of stock is
realised, and there is an amount receivable that is ascertained and is not subject to any contingency (J. Rowe & Son Pty Ltd (1971) 124 C.L.R. 421). At least this is so when the taxpayer is on an accruals basis in relation to business gains, and there may be room for an argument that the trading stock provisions are confined to a taxpayer on an accruals basis. The striking of a profit in relation to an item that is a revenue asset but is not trading stock may depend on realisation and cash receipts. And Thorogood (1927) 40 C.L.R. 454, decided at a time when it was assumed that the trading stock provisions did not apply to land, may support a view that there may be several moments of striking of a profit where cash receipts in respect of an item extend over a period of time. An approach, called a “profit emerging” approach, in one usage of that phrase, may be taken so that there is a derivation of a profit, potentially in an amount receivable, as that amount receivable is received in cash. There is thus a derivation of profit as each receipt of cash occurs in circumstances where the receivable is actually received over a period of time. Alternatively, the profit is derived when the amount actually received comes to exceed cost, and thereafter as each further receipt of the amount of the receivable occurs. It is sometimes said that this approach requires the application of a cash basis in the determination of a specific profit. It will be apparent that cash basis in these circumstances is different from cash basis when the accounting regime applicable is receipts and outgoings.

12.12 If the striking of a profit depends on a cash receipt it may be asked whether it also depends on all outlays having been made in cash. It would be surprising if the taxpayer could defer the striking of a profit that is income by omitting to pay his debts. At the same time, it might be thought that the receipt of proceeds of realisation of an asset should not be a moment of striking a profit that is income if there is a contingent liability resting on the taxpayer in respect of the revenue asset realised, or the amount of a liability resting on him is not yet ascertained. In circumstances such as in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106 the commission payable to a broker in relation to the acquisition of securities may be the subject of dispute. The commission may not be regarded as a cost of the securities: it may be treated as an outgoing deductible as incurred. But if it is seen as a cost, the striking of a profit would be indefinitely delayed. In these circumstances, the striking of an estimated profit may be proper, the estimate being open to correction by an amended assessment under s. 170(9), though only at the initiative of the Commissioner. The taxpayer, where a correction would favour him, should be given power to compel the Commissioner to amend.

12.13 The observations so far made in relation to the striking of a profit
bear equally on the striking of a loss. Where the trading stock provisions are applicable, what is in effect a loss will arise where the proceeds of realisation are less than the deemed deductible outlays.

12.14 Where the item is a revenue asset that is not trading stock, a loss will arise and be deductible under s. 51(1) if it can be said to be incurred in “gaining or producing income”. The deductibility of a loss under s. 51(1) was the subject of comment in [5.14]-[5.22] and [10.65]ff. above.

12.15 The class of revenue assets to which specific profit or loss accounting may be applicable is not confined to assets that are acquired and disposed of in the conduct of business operations. A revenue asset includes a receivable that may be the subject of an exchange gain or loss or a bad debt loss, and there may be a liability on revenue account that can give rise to an exchange gain or loss, or a gain that arises from a relief from the liability. Specific profit accounting in the circumstances is considered in [12.185]ff. below.

12.16 The discussion so far has been concerned with non-wasting revenue assets. Specific profit accounting may be appropriate to wasting revenue assets. Comment was made in [11.10]-[11.11] above that an outlay on a wasting revenue asset should be treated as an outgoing only to the extent that the advantage that is acquired by the outlay is absorbed during the year of income in the business of the taxpayer. The view thus adopted expresses a general principle that an outlay, though otherwise presently incurred, becomes a deductible outgoing only as it is consumed. If there is a realisation of the asset before the advantage that it gives is totally absorbed, specific profit or loss accounting becomes appropriate. The determination of the amount of the profit or loss will give effect to s. 82, so that an outlay which has already been allowed as a deduction will not thereafter be brought into the resolution of costs and proceeds which is reflected in a specific profit or loss.

12.17 The effect of the principles thus asserted may be illustrated in relation to spare parts acquired by a business to be used in the repair of assets used in the business—the situation in *Guinea Airways Ltd* (1950) 83 C.L.R. 584. An outlay on spare parts is not a presently deductible outgoing. There is as yet no using up of the advantage that the spare parts afford. For this reason it would be argued that the view expressed by Latham C.J. in *Guinea Airways*, that an outlay on spare parts is deductible when incurred, should be rejected. If a spare part is used in effecting a repair, there will be a deduction of the outlay as an expense of the repair. The outlay at this time becomes an outgoing consumed. If the spare part is realised in a business disposition, there will be a profit that is income to the extent that proceeds exceed costs, or a loss that is deductible if the proceeds are less
than cost. If the taxpayer is deprived of the spare parts by an event that is relevant to the business operations, as in *Guinea Airways*, there is a realisation which will give rise to a profit or loss that is income or deductible. If a receipt is generated by the event—for example, an insurance receipt—that receipt will enter the calculation of the profit or loss. If there is no receipt, there will be a loss in the amount of the cost of the spare parts. This, it would be claimed, is a preferable analysis to what may appear to have been suggested by Kitto J. in *Guinea Airways*, an analysis that would regard the deprivation as involving a “gross loss” which, it is said, is the “loss” to which s. 51(1) refers. “Gross loss” would describe the value of the item of which the taxpayer has been deprived. To give the taxpayer in a *Guinea Airways* situation a deduction of this amount would be to confound principle, unless an item of income were first recognised in the amount of the excess of the value of the spare parts at the time of deprivation over their cost. It is not clear that Kitto J. did intend such an analysis. Other observations in his judgment are consistent with the view taken in this Volume that the “loss” referred to in s. 51(1) is the failure of an asset to realise its cost.

12.18 Specific profit accounting within a continuing business will be appropriate where a taxpayer engages in ventures which are repetitive and in their totality are of a sufficient scale and sufficient system to amount to a continuing business of engaging in such ventures. The fact that any one of several ventures, if it stood alone, would not be an isolated business venture, a profit from which would be income by ordinary usage, does not preclude a conclusion that the totality of ventures amounts to a business and a specific profit arising from each venture is income. Where a taxpayer is held to have engaged in a business of gambling, he will derive income in the form of specific profits on gambling transactions and be allowed deductions for losses. An isolated gambling venture would not be an isolated business venture that could produce a profit that is income or a loss that is deductible.

12.19 The fact that a venture is an aspect of a continuing business does not require that receipts and outgoings accounting must be applied to the exclusion of specific profit accounting. Which is not to say that it may not be appropriate to apply receipts and outgoings in a particular case, because it will give a better reflex of income. Whether specific profit accounting, or receipts and outgoings accounting already applicable in other respects, is appropriate to the contracts of a builder will depend on the nature of the individual contract, and it may be proper to apply specific profit accounting to some contracts, while others are governed by the generally applicable receipts and outgoings accounting. In this area specific profit
accounting is not dictated. The outlays are not costs of non-wasting revenue assets.

12.20 It will be seen in [12.37]ff. below that where a specific profit accounting is applied to an isolated business venture, no distinction is drawn between costs that are currently deductible as outgoings, and costs that enter the determination of the specific profit. All costs enter the determination of the specific profit. Where specific profit accounting is applied to a venture within a continuing business there will be outlays that are outgoings and currently deductible. In the result there will be a need to distinguish costs that are to be treated as costs of a venture, and costs that are currently allowable outgoings. Drawing the distinction raises questions of the kind already considered in relation to a continuing business that acquires and disposes of revenue assets.

Accounting for a loss

12.21 Accounting for a loss where a revenue asset of a continuing business is realised depends on the answers to questions of principle of a fundamental kind. In [10.273] above it was said that an acceptable rule might assert that where there is a continuing business a loss is deductible in circumstances where a profit would have been assessable income. The rule assumes that the realisation of the revenue asset was an act done in carrying on the continuing business. Where the realisation is not in the carrying on of the continuing business, it is arguable that there is an abortion of the business purpose in relation to the asset realised and there can be no profit that is income or loss that is deductible arising from the realisation. There is some authority that where revenue assets are sold in a disposition of the business, or in a sale that is made in immediately putting an end to the business, no profit that is income or loss that is deductible can result (C. of T. (W.A.) v. Newman (1921) 29 C.L.R. 484), but there is no authority that would support the argument in its widest application.

Accounting on a disposition not in the ordinary course of business

12.22 Section 36 has been included in the trading stock provisions to ensure that an amount, being the market value of the asset, is included in assessable income in circumstances where there is an abortion of business purpose by a disposition of trading stock otherwise than in the ordinary course of carrying on the business. Section 36 is demanded by the trading stock provisions which allow a deduction of the cost of an item of trading stock, in effect at the time when the item ceases to be “on hand”. The notion “on hand” does not require any element of carrying on business in
the event by which the taxpayer ceases to own the item.

12.23 In the present context of the realisation of revenue assets that are not trading stock, the law could tolerate a view that would treat a realisation other than in carrying on the business as not productive of a profit that is income or a loss that is deductible. But the virtue of such law may be doubted. Sharkey v. Wernher [1956] A.C. 58 is a United Kingdom authority which could appropriately be adopted. The case concerned what may be seen as only a notional realisation—the taking of a revenue asset from a business and the use of it for private purposes. The principle requires that the realisation be treated as a realisation at market value. In subsequent United Kingdom decisions the principle of the case has been applied to an actual realisation not in the ordinary course of carrying on the business. At the same time it has suffered a restriction by the decision in Mason v. Hammond Innes [1967] 2 W.L.R. 479, so that the principle does not apply to a taxpayer who accounts on a cash basis. And, presumably, it does not apply to a realisation in putting an end to business operations.

12.24 If a Sharkey v. Wernher principle is not adopted as part of the Australian law there will be distortions, which may not be destructive of the integrity of the income tax, but may none the less be considered unacceptable. The extent of the distortion will depend on how much of outlays that relate to revenue assets have been denied deduction. The point was made in [12.8]–[12.10] above that the scope of outgoings that are to be seen as costs of revenue assets and not deductible, may be wider or narrower dependent on whether a direct cost or an on-cost approach is taken. If an on-cost approach has been taken the extent of distortion is at a minimum. If a direct cost approach has been taken and deductions have been allowed of costs that relate to revenue assets, the failure to deem the realisation to have been made at market value will produce a distortion: deductions will have been allowed that are not matched by an item of gain that is income. In theory it might be possible to adopt a principle which would in effect reverse the allowance of the deductions by bringing in as income an amount equal to those deductions. But there are obvious difficulties in identifying those deductions.

12.25 The Sharkey v. Wernher principle should be adopted and extended to all realisations of property not in the ordinary course of business, whether they are occasional realisations or are realisations in the disposition of the business, or in the disposition of assets in an act of bringing the business to an end. Authorities dealing with dispositions in putting an end to the business should not be followed. The limitation of the principle imposed in Mason v. Hammond Innes should not be adopted. The limitation defeats the function of the principle for no apparent reason. The reason given by
Lord Denning for rejecting the principle—that it would extend to a professional artist who paints a picture of his mother and makes a gift of the picture to her—is not persuasive. If he paints the picture in the course of his business it is a revenue asset, whoever sits for the picture, and the *Sharkey v. Wernher* principle should apply to whomsoever he makes the gift. If he does not paint the picture in the course of his business—if he paints it in filial devotion—the *Sharkey v. Wernher* principle will not apply, whether he in fact gives it to his mother or to some other person. If he sells the item, there will not be a profit that is income unless the item can be said to have been taken into his business. In which event a deemed cost of the value of the item at the time it was taken in will be a cost in computing the profit. None of the costs of painting the picture should have been allowed as deductions or will be treated as costs of the picture.

12.26 The operation of a *Sharkey v. Wernher* principle depends on there having been a withdrawal of the revenue asset from the process of income derivation in which it was held. The taking for a private purpose of a revenue asset of a business, as in *Sharkey v. Wernher* itself, is one illustration of circumstances to which the principle applies. Another illustration would be the taking of the revenue asset from a business and the holding of it thereafter in a different business of the same taxpayer, or in another process of income derivation, including a s. 25A(1) process. All other illustrations will involve some disposition otherwise than in the ordinary course of carrying on the business. All circumstances to which the principle would apply could be described as partial abortions of a process of income derivation.

12.27 Section 36 in relation to trading stock has no application to the taking of an item for a private purpose, or the taking of an item from a business into another process of income derivation. In this respect the section may be thought to be deficient. The matter is more closely considered in Chapter 14 below.

12.28 The notion of a disposition which is not in the course of carrying on a business is a creature of a principle of tax accounting, though it has its parallel in the s. 36 notion of a disposition “not in the ordinary course of carrying on [the] business”, a creature of the words of the Assessment Act. The tax accounting notion has its expression in a number of United Kingdom cases, most important being *Skinner v. Berry Head Lands Ltd* [1970] 1 W.L.R. 1441 and *Petrotim Securities Ltd v. Ayres* [1964] 1 W.L.R. 190. In *Skinner v. Berry Head Lands* an inference that the transaction was not in the course of business was drawn from the “enormous disparity” between the price at which the revenue asset was sold and its market value, and the fact that the sale was made to the
taxpayer’s parent company. In *Petrotim Securities* a like inference had been drawn in respect of a sale at a “gross under-value” by a company to its parent company.

12.29 Australian authority is concerned with the operation of s. 36. In *Pastoral & Development Pty Ltd* (1971) 124 C.L.R. 453 at 464, Walsh J. held that a sale of trading stock was at a price “that was an arbitrary one and was so low as to take the transaction outside the category of an ordinary business transaction”. At the same time he observed (at 463):

“I do not assert as a general proposition that a sale by one company to an associated company upon terms that allow the latter to make a substantial profit and give the former less profit than otherwise it might be possible for it to make is never a sale in the ordinary course of the carrying on of the business of the former company. It is common enough that business is conducted in that fashion between associated companies, not by way of an exceptional and isolated transaction, but as a regular method of trading . . .”

The United Kingdom cases in the paragraph and the Australian case are concerned with transactions in the course of profit-shifting between associated companies. In Australia, at least, where grouping was not until recently allowed so as to apply the losses of one company against the profits of an associated company, it may have been appropriate to treat profit-shifting between associated companies as action in the course of carrying on a business. Where however a disposition is made not to an associated company engaged in business but to some associated person who will acquire the property for a private purpose, a conclusion that the sale is not in the course of business should be more readily drawn from the circumstances that the sale is for an amount less than the market value of the asset sold. Where the sale is in the course of profit-shifting and it is held to be in the course of business of the seller, the buyer will take the asset with a cost of the price at which the item was sold to him. At least that is the assumption in the United Kingdom cases. And the assumption draws support from the decision of Plowman J. in *Jacgilden (Weston Hall) Ltd v. Castle* [1969] 3 W.L.R. 839, though there remains room for an argument that so far as there is an element of gift in a sale at an undervalue, that element of gift should be brought to account as a cost in determining the profit of the buyer that will be his income. The matter is more closely examined in [12.78]–[12.88] below. The general principle of tax accounting must be that property that is not received in carrying on or carrying out a process of income derivation, but may be said to have been brought into that process, must be give a cost equal to its market value at the time it is brought in to the process. Where property is purchased in a transaction that reflects an element of gift by the seller, and that element of gift is not received in the process of income derivation, the part of the property that may be said to have been given must be given a cost of the market value of that part. In effect the cost of the whole property to the buyer must be increased to its market value. If the general principle is held applicable to the situation of the buyer, the appropriateness of treating the sale as a realisation at market value by the seller becomes more compelling.

12.30 The notion of disposition other than in the course of carrying on a business needs to be applied not only in relation to revenue assets, whose
disposition is at all times expected in the carrying on of the business, but also to revenue assets that are expected to be consumed in the carrying on of the business—wasting revenue assets—or are expected to be realised by the receipt of payment—receivables on revenue account. A taxpayer who holds import licences which may be expected to be consumed in the carrying on of his business may sell those licences to another. Whether the disposition is in the course of business will be determined by considerations already examined in regard to assets held for disposition. A taxpayer may factor his receivables on revenue account and none the less act in the course of business, though his general practice is to await payment of his receivables. Again the considerations already examined in regard to assets held for disposition will be relevant.

12.31 The disposition of a wasting revenue asset may give rise to a profit that is income or a loss that is deductible, if it is made in the course of business. The calculation of the profit or loss will be made having regard to s. 82. If the disposition is not in the course of business, there is need of an extended Sharkey v. Wernher principle if there is to be a profit that is income or a loss that is deductible. The Sharkey v. Wernher principle in United Kingdom authority may not go so far. The limitation imposed on the principle by Mason v. Hammond Innes [1967] 2 W.L.R. 479 confines it to situations where the asset in question was held for disposition. The reasoning in the latter case in fact shifts between a limitation in terms of a requirement that a cash basis of accounting is applicable to the taxpayer's business, and a limitation in terms that the assets must be trading stock.

12.32 The discussion in previous paragraphs has been concerned with the tax consequences of a disposition of property by way of gift or for an amount less than its market value. There are distinct but parallel issues that arise where there has been a disposition for an amount greater than market value. The disposition may be an aspect of a plan to shift profit from one associated entity to another, so that the profit arises in the entity disposing of property rather than in the entity taking the disposition. Or it may be that the fixing of the consideration at an amount greater than market value is an aspect of a gift intended by the person taking the disposition.

12.33 One view would be that the disposition at greater than market value indicates that the disposition is not in the course of business, so that there has been a partial abortion of the business operation. The consequence would be that there is no income derived unless some provision prevents the abortion. Section 36 is such a provision, though it might be thought surprising that the section should operate to deem a disposal to have been made for an amount less than the actual consideration. The operation of the section would deny the person acquiring a cost of the actual amount paid:
his cost would be limited to the value at which the seller is taken to have
disposed. If a *Sharkey v. Wernher* principle is held to be part of the law and
to apply, it would have the same effect.

12.34 Another view would say that an element of gift by the buyer in a
receipt by a seller is not to be regarded as proceeds of sale that should enter
the determination of the seller's profit that is income. The income quality of
the element of gift will need to be judged for itself—it may be that it is a
product of services preformed by the seller and income in his hands on that
ground. The treatment of the price paid to the seller would raise similar
issues. A payment for property which reflects a gift made by the buyer may
be seen as only in part a cost of the property. Its characterisation in other
respects must be determined by the purpose of the payment, and the tax
consequences for the buyer will depend on that purpose.

12.35 This exploration of possible lines of analysis leads back to some of
the most intractible areas of income tax law—the effect of *McLaurin*
(1961) 104 C.L.R. 381, and *Allsop* (1965) 113 C.L.R. 341 in regard to the
dissection or apportionment of a receipt and the effect of *Europa Oil (N.Z.)
Ltd v. C.I.R. (N.Z.)* (No. 2) (1976) 76 A.T.C. 6001 and *South Australian
Battery Makers Pty Ltd* (1978) 140 C.L.R. 645 in relation to identifying
distinct purposes in a payment and consequent apportionment of an
outgoing. An appropriate response would be to say that those cases are
concerned with receipts and outgoings accounting, and the present concern
is with specific profit accounting in relation to which considerable
flexibility is allowed. It is true that receipts and outgoings accounting does
apply where trading stock is involved, but in that area s. 36 is available to
achieve the same result as profit accounting should allow.

12.36 It is evident that the operation of the tax system would not tolerate an
examination of every transaction in search of a disparity between the price
W.L.R. 839, in rejecting the application of the *Sharkey v. Wernher*
principle where there has been a sale and acquisition by an “honest
bargain”, sets the limit on the room for examination.

**Specific Profit Accounting in its Application to an Isolated
Business Venture**

12.37 It is only since *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355, at
least in modern experience, that it has been clearly recognised that a gain
from carrying out an isolated business venture will be income. There may
continue to be doubt whether a loss from carrying out such a venture is
deductible. When, in 1930, the equivalent of s. 25A(1) was added to the
1922 Act, it would not have been doubted that the principles established in the United Kingdom expressing the notion of “adventure in the nature of trade” belonged to the ordinary usage meaning of income and were part of the meaning of income for purposes of the Assessment Act. However, the attention given to the former equivalent (s. 26(a)) of s. 25A(1) by the Commissioner’s assessments, and by the courts in their decisions, rather suggested that the provision was to be regarded as a code fixing the meaning of income in isolated venture situations, to the exclusion of that aspect of the ordinary usage meaning concerned with isolated ventures. The principal significance of the decision in *Whitfords Beach* is a rejection of the suggestion that s. 25A(1) is a code displacing some of the ordinary usage meaning of income. Indeed Gibb C.J. and Mason J. would relegate s. 25A(1) to a role in determining the meaning of income for the purposes of the Assessment Act which would deny that it applies to any of the field that is covered by the ordinary usage meaning. To some extent their view is dictated by a parallel provisions and two meanings analysis of the structure of the Assessment Act, which in the view of this Volume is an incorrect analysis. But their view can equally be accommodated to a single meaning and central provision analysis. Denying that s. 25A(1) applies to any of the field that is covered by the ordinary usage meaning asserts a conclusion that s. 52 has an operation limited in the same way.

12.38 The tax accounting appropriate to the determination of a specific profit from an isolated business venture has not been the subject of any detailed judicial examination. In *Whitfords Beach* the parties agreed that the trading stock provisions were inapplicable, presumably because they did not see the facts as giving rise to a continuing business. The suggestion has already been made that the conclusion in *St Hubert's Island Pty Ltd* (1978) 138 C.L.R. 210 that the trading stock provisions were applicable was a conclusion that there was a continuing business. If the trading stock provisions had been treated as applicable in *Whitfords Beach*, accounting for specific profit would have had no place.

12.39 The other aspect of the agreement between the parties in *Whitfords Beach* was that the taxpayer, in determining the amounts of any specific profits arising from the isolated business venture, was entitled to treat the value of the property at the time the venture commenced as a cost. The matter of when the venture had commenced was referred back to the Federal Court and a decision made by that court: *Whitfords Beach Pty Ltd* (1983) 83 A.T.C. 4277.

12.40 The inference from the assessments that had been made by the Commissioner in *Whitfords Beach* (1982) 150 C.L.R. 355, which are referred to in the High Court judgment, is that he did not allow any
outgoing deductions. The assumption is that an isolated business venture to which specific profit accounting applies does not have any currently deductible outgoings. All outlays are costs of assets that will be realised and have tax consequences only in the determination of specific profits. It would follow that the expenses of administering the land development were not currently deductible. And interest payments on money borrowed to meet development costs were not currently deductible. The specific provisions of the Assessment Act allowing deductions against assessable income, including the depreciation provisions, may offer some guidance as to what are subtractable costs, but they are not definitive. And provisions specifying the manner of a deduction are not definitive. Thus s. 51(3), requiring payment before a long service leave expense is deductible, does not preclude the subtraction of a provision for such an expense in determining a specific profit.

12.41 In *Whitfords Beach*, as land was sold, the tax accounting in *Thorogood* (1927) 40 C.L.R. 454 became applicable. That accounting brings in profits as parcels of land that result from the development are disposed of. A profit in respect of any parcel will involve a surplus of proceeds over costs applicable to the parcel. The costs applicable will reflect a spreading of costs over all the land involved in the development. There will be questions as to how the spreading is to be done. Observations by Windeyer J. in *Elsey* (1969) 121 C.L.R. 99 at 110-111, made in relation to a development subject to the second limb of s. 26(a) (now s. 25A(1)), suggest that an average cost is inappropriate save where each parcel is of a relatively uniform kind. Profits will be income as they “emerge”, which in this context may mean as proceeds of realisation are received in excess of costs, or in the proportion that proceeds received bear to proceeds receivable. In the latter situation a calculation must be made of potential profit from a realisation, reflecting the excess of the sale price over costs, and that potential profit will be income in the proportion that receipts bear to the sale price.

12.42 A number of more detailed aspects are unresolved. The fact that a cost has not yet been the subject of an actual payment should not preclude the striking of a profit. Presumably the liability is none the less to be regarded as a liability on revenue account, that may give rise to a deductible loss, or a profit that is income when it is discharged. There may be an exchange loss or profit, or a profit that is income arising in the circumstances of *British Mexican Petroleum Co. Ltd v. I.R.C.* (1932) 16 T.C. 570, and despite the decision to the contrary in that case.

12.43 There may be a liability that is contingent, or the liability may be of an amount not yet ascertained. The point was made in connection with
accounting on the realisation of revenue assets of a continuing business ([12.12] above) that the striking of a profit cannot be made to wait until the contingency has occurred or cannot now occur, or until the amount of the liability is ascertained. In these circumstances it was suggested that an estimate must be made of this part of the cost, and a profit struck. The Commissioner will have power, in effect, to correct the estimate by an amended assessment under s. 170(9). The taxpayer, where a correction would favour him, should be given power to compel the Commissioner to amend.

12.44 *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 is illustrative of a specific profit from an isolated business venture that concerns the realisation of property of the taxpayer. There may be an isolated business venture where profit is to be made otherwise than by a realisation of property. A building or construction project on the land of another is the obvious illustration. The tax accounting applicable in these circumstances is examined in [12.64]ff. below.

12.45 *Whitfords Beach* was concerned with the profits that may arise from an isolated business venture which, it may be assumed, will be carried out to completion. There is thus a notion of a realisation in the course of carrying-out the isolated business venture which corresponds with a notion of realisation in the course of carrying on a continuing business. If a loss arises on such a realisation it will be deductible under s. 51(1). There may however be a particular realisation which is not in the course of carrying out the venture. In which event the question is raised whether the realisation should be treated as a partial abortion of the venture that cannot give rise to profit that is income or loss that is deductible. The principle in *Sharkey v. Wernher* [1956] A.C. 58 will need a substantial extension of its scope beyond any allowed to it by *Mason v. Hammond Innes* [1967] 2 W.L.R. 479 if it is to operate. Its operation would be to treat the realisation as having been made for market value, and to treat any resulting profit or loss as income or deductible. However to accept that there has been a partial abortion is the easier in this context than in the context of a continuing business where some deductions of current expenses relating to the item realised may have been allowed.

12.46 A *Sharkey v. Wernher* principle could be imagined that would extend to a general abortion of an isolated venture. The assumption of *St Hubert's Island* (1978) 138 C.L.R. 210 is that there is no such principle. The importance to the Commissioner of a conclusion that there was a continuing business to which the trading stock provisions were applicable lay in the resulting availability of s. 36. There was no suggestion in the case that the Commissioner might have succeeded in any event by the
operation of a *Sharkey v. Wernher* principle. Indeed the view expressed in dissent by Stephen J. (following Mahoney J. at first instance)—that the land was not yet in such a state that it was trading stock so that the Commissioner could not succeed—implies rejects *Sharkey v. Wernher* where there is a realisation of revenue assets in disposing of a business, or in a disposition that brings the business to an end. Section 36 thus appears as a special provision with a narrow field of operation: it is not backed by a general principle drawn from ordinary usage principles.

12.47 If there is no *Sharkey v. Wernher* principle to be applied in circumstances of a general abortion of an isolated venture, there will not be a realisation of profits in a *Whitfords Beach* situation, if, after some carrying out of development, there has been a liquidation of the company and the taking of the developed land by the shareholders in satisfaction of their rights as shareholders. Nor will there be a realisation of profits in a *Whitfords Beach* situation if, the market for land having become depressed, the company decides to build houses on the land and hold it as an investment for rental returns. This is to assume that those circumstances would involve a general abortion. It may be arguable that there is no abortion that could involve the present operation of a *Sharkey v. Wernher* principle. If the land market improves, the company may then decide to sell, and it is arguable that the isolated venture has experienced no more than a suspension. Whether or not there has been an abortion must depend on the definition of the venture. The more particularity there is in that definition, the easier is a conclusion that the circumstances have involved an abortion. The matter is the subject of some comment in relation to the second limb of s. 25A(1) in [3.73] above and is approached again in that connection in [12.49]-[12.50] below.

**Specific Profit Accounting in its Application to Section 25A(1) and Section 26AAA Situations**

12.48 Some attention has been given in Chapter 3 above to the tax accounting appropriate to a transaction within s. 25A(1). There is an observation by Kitto J. in *Becker* (1952) 87 C.L.R. 456 at 467 which suggests a liberality in regard to tax accounting, justified by the word “profit”, which contrasts with the rigidities of interpretation of other words of s. 25A(1). He said:

“[Section 25A(1)], unlike the provisions with which the court was concerned in the cases cited, uses the language of everyday affairs without artificial restriction or enlargement. Whether a given amount is to be characterised as a profit within the meaning of the provision is a question of the application of a business conception to
the facts of the case. This does not mean that formal steps that have been taken are to be ignored on the ground that the same result might have been achieved in another way; but it does mean that, however many and complicated the steps employed may have been, a profit is not found to have arisen until there has been deducted from the ultimate sum received the amount or value of all that in fact it has cost the recipient to obtain that ultimate sum.”

The tax accounting thus envisaged would be generally consistent with the accounting suggested in [12.37]-[12.47] above, applicable to an isolated business venture. But there may be some differences. The reference to “ultimate sum received” indicates that a profit that is income arises only on actual receipt. It may also indicate a view that there is no profit to be struck until all of the amount receivable has been received, which would preclude the kind of profit emerging approach referred to in [12.41] above. It may not however be appropriate to take the case as deciding that such a profit emerging approach is precluded. The liberality proposed would leave room for choice of an approach that will best reflect income. Yet there are problems associated with a derivation of profit that is income in advance of receipt of the total proceeds of realisation. If a profit is treated as emerging and being derived in the proportion cash received is of cash receivable, there is a question of the effect of a failure of cash receipt in respect of the remaining cash receivable. The receivable is not readily seen as a revenue asset in respect of which a bad debt loss under s. 51(1) may be experienced. In any case, to allow a deduction on the failure of the receivable to realise its remaining amount, would be to produce a distortion in tax accounting. More appropriate would be a reopening under s. 170(9), of the earlier assessments, but that reopening is not a matter of any right in the taxpayer. The initiative is with the Commissioner. Most appropriate would be to allow a deduction of the amount by which the profit that has been treated as already emerged and included in income, exceeds the total profit that has in fact emerged, having regard to the failure of the receivable.

12.49 The drafting of s. 25A(1) raises special issues in regard to the consequences of an abortion. It would be generally assumed that the profit making process under the first limb cannot be aborted save by a disposition that does not amount to a sale. If there is an acquisition with the relevant purpose, a change of purpose cannot in itself bring about an abortion. The taxpayer may change his purpose to one of holding for investment. When eventually he does sell, there will be an operation of the section if there is a surplus of receipts over cost. Implicit in this analysis would be a surprising consequence. If it be assumed that he gave notice under s. 52(1) after acquisition, he would be entitled to a loss deduction if he sold for a price
that is less than cost, even though the sale price had been chosen in a transaction between associated persons so as to bring about a loss. Such a consequence is now, however, precluded by subs. (5)(a) added to s. 52 in 1984.

12.50 An approach that would recognise that there can be an abortion even though there has been a sale would focus on the word “profit” in s. 25A(1) and the word “loss” in s. 52(1) and assert that there is no profit or loss realised on sale unless the property has been sold in a transaction which does not involve an element of donation given or received. Such an approach would reinforce s. 52(5)(a) in regard to a deduction for a loss. But it would involve the consequence that a taxpayer might resist the inclusion in his income of an excess of proceeds over cost by insisting that he had sold at more or less than market value, in order that he might receive from or make a gift to the buyer. An alternative approach that would avoid such a consequence, would assert that there is no abortion, but the transaction should be seen as the receipt of proceeds to the extent of the market value of the property and the making of a gift by the taxpayer, or a receipt of proceeds to the extent of market value, and the receipt of a gift. Such an approach would achieve for purposes of s. 25A(1) first limb what is achieved for purposes of s. 26AAA by s. 26AAA(4). It will be noted that s. 26AAA(4) in the determination of a profit extends to both a sale at more than market value, and a sale at less than market value.

12.51 Other aspects of tax accounting in relation to a s. 25A(1) first limb profit, involving the new provisions in subss (2)-(12) of s. 25A, are examined in Chapter 3 above.

12.52 There are some special issues in relation to tax accounting for a s. 26AAA profit. It would be readily accepted, more especially since Bernard Elsey Pty Ltd (1969) 121 C.L.R. 119 and Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355, that the cost of property in a s. 25A(1) second limb transaction must be the market value of that property at the time it is taken into the scheme, if it was not acquired in the carrying out of the scheme. And, perhaps less readily, it would be accepted that any element of donation by the person from whom property is acquired in a transaction of acquiring property for the purpose of profit-making by sale must be valued and treated as a cost of that property for purposes of the first limb of s. 25A (1). But it may not be accepted that an element of donation by the vendor in a “purchase” for purposes of s. 26AAA should be treated as a cost of the property purchased. There is perhaps room for an argument that s. 26AAA (4) expressly provides in a way that does make the element of donation a cost to the purchaser where that section has operated so as to deem the vendor to have sold at market value. In having provided expressly in this
way, the argument would run, the section precludes any operation of a
general principle that would treat the value of the element of the donation
as a cost. The fact remains that s. 26AAA is concerned with “profit”
arising from sale. A taxpayer who acquires property by gift and sells it,
might be said to profit by the receipt of the gift but he does not profit by
the sale except to the extent that the sale price exceeds the value of the
property at the time of the acquisition by gift.

12.53 A too literal reading of s. 26AAA may give it an operation that will
make it incoherent. Section 26AAA(1)(f) provides that the receipt of
property on transfer from another without consideration is a deemed
purchase. It is said that the transfer of property to a shareholder in the
liquidation of a company, or, indeed, in the payment of a dividend in
specie, or the transfer of property to a beneficiary by a personal
representative in the administration of a deceased estate, is a transfer
“without consideration”. When this view is combined with a view that the
value of the element of donation in a transfer of property is not to be seen
as a cost of the transferee's acquisition, the shareholder or beneficiary who
sells within 12 months of the transfer to him will derive income to the
extent of the gross proceeds of sale. The view that the transfer is “without
consideration” might be countered by reliance on the reasoning in Howie
(Archipald) Pty Ltd v. Commissioner of Stamp Duties (N.S.W.) (1948) 77
C.L.R. 143. Whether or not it can be countered successfully, there is a
distinct issue whether a conclusion that the transfer is without
consideration carries the consequence that the transferee does not have a
cost for the purposes of determining the profit which is his income arising
on sale of the property.

12.54 Section 26AAA(4) has a function which has its parallel in s. 36 or in
the principle in Sharkey v. Wernher [1956] A.C. 58. Section 36 and a
Sharkey v. Wernher principle preclude the abortion of a process of income
derivation by deeming a disposal which is outside the process to be a
disposal at market value, a deeming which it is assumed in each instance
will bring the disposal within the process. Section 26AAA(4), in
combination with s. 26AAA(1)(f), deems there to be a sale at market value
where property is transferred from one person to another and those persons
in the opinion of the Commissioner were not dealing with each other at
arm's length, and any consideration for the transfer, in the opinion of the
Commissioner, is less than the value of the property. It has been seen that
there may be doubts about the operation of a Sharkey v. Wernher principle,
at least in relation to an isolated business venture, and it presumably has no
application to transactions within s. 25A(1). There are in the result
significant areas where there can be an abortion of a process of income
derivation which will leave the process without any tax consequences if s. 26AAA, in particular s. 26AAA(4), does not operate. The scope of the operation of s. 26AAA is then of major importance. Section 26AAA may operate as a reserve force for the Commissioner where there has been an abortion of a process of income derivation within s. 25A(1). Section 26AAA (5)(a) provides that the principal operative provision of the section, in s. 26AAA(2), “does not apply in relation to a sale by a taxpayer of property if the property was included in the assets of a business carried on by the taxpayer and, as a result of the sale, an amount will be included in the assessable income of the taxpayer of the year of income under a provision of this Act other than this section”. Section 26AAA may therefore operate as a reserve force to bring about tax consequences where abortion has defeated the operation of a process of income derivation involving the carrying on of a business. In the result the relationship between the operation of s. 26AAA and principles expressed in the ordinary usage meaning of income is very different from the relationship between the operation of s. 25A(1) and those principles, at least as the latter relationship is seen by Gibbs C.J. and Mason J. in *Whitfords Beach*.

The operation of s. 26AAA as a reserve force is of course limited by the time span within which a transaction must be completed if the section is to operate.

**Receipts and Outgoings Accounting in its Application to an Isolated Business Venture**

12.55 *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 is a landmark in the history of the income tax in the recognition—it is true only in the agreement between the parties—that specific profit accounting is applicable in relation to events that give rise to income within the ordinary usage meaning of the word. There are occasions still when the assertion is made that tax accounting for purposes of s. 25(1) is distinct from tax accounting for purposes of s. 25A(1). Section 25(1), it is said, is concerned only with the bringing in of receipts—“gross income”. Section 25A(1), it is said, is concerned with a distinct notion of income, one that involves a balance of proceeds over costs. The assertion has been associated with a parallel provisions analysis, and a two, or perhaps multiple, meanings analysis, of the structure of the Assessment Act, analyses that have been rejected in this Volume. The demise of the assertion may in turn bring on the demise of those analyses ([1.31]ff. above).

12.56 An exclusively receipts and outgoings accounting is possible only when there are no outlays on non-wasting assets, or where the trading stock
provisions are applicable to all non-wasting assets. An exclusively specific profit accounting is possible, in theory, in all situations. The law will determine which of possible methods of accounting is appropriate. An exclusively specific profit accounting would presumably never be appropriate to a continuing business. On the other hand, receipts and outgoings accounting, exclusive as far as it can be, may be appropriate to an isolated venture. Receipts and outgoings accounting was adopted in *New Zealand Flax Investments Ltd* (1938) 61 C.L.R. 179, though the process of income derivation, at least in the period until regular harvesting would have begun, could be seen as an isolated business venture.

12.57 Specific profit accounting for an isolated venture, if applied in *New Zealand Flax* would have delayed the derivation of income by the company until the work of establishing the flax plantation and bringing it to the productive stage was complete. At least this would have been so, unless the kind of profit-emerging accounting that may be appropriate to a building contract could have been applied. Profit emerging accounting of this kind is considered in [12.64]ff. below. It may involve the emergence of a profit that would as yet be said to be unrealised.

12.58 The receipts and outgoings accounting in fact adopted by the High Court in *New Zealand Flax* lacked the principles now associated with the decision in *Arthur Murray (N.S.W.) Pty Ltd* (1965) 114 C.L.R. 314. With the principle in *Arthur Murray* receipts and outgoings accounting might be thought more appropriate to the facts of *New Zealand Flax* than specific profit accounting.

**Profit or Loss “Realised”, and a Profit or Loss “Arising” or “Emerging”**

12.59 There is a financial accounting convention that would assert that a profit should not be recognised until it is “realised”. There is another convention that an impending loss should be “anticipated”. Both conventions reflect a principle of conservatism in accounting—that the profit stated for a period should not mislead investors and creditors by being overstated.

12.60 The convention that a profit should not be recognised until it is “realised” is reflected in a principle of receipts and outgoings tax accounting that, even though accruals is the basis of accounting, an item is not derived until it is of an ascertained or ascertainable amount, and there is no element of contingency about the right to receive it. The convention that a loss should be anticipated is reflected in receipts and outgoings tax accounting applicable to trading stocks: s. 31 allows a taxpayer to value
closing stock at market selling value, so that he may by his valuation anticipate a loss in circumstances where market selling value has fallen below cost. It is true that s. 31, contrary to financial accounting convention, also allows the taxpayer to anticipate a profit where market selling value is above cost. It does not, of course, compel an anticipation, and the taxpayer may be expected to make use of the election to value at market selling value if this is above cost only in exceptional circumstances: he may wish to anticipate income so that it might be absorbed by an ordinary loss carried forward that will otherwise be defeated by lapse of time.

12.61 The principle in *J. Rowe & Son Pty Ltd* (1971) 124 C.L.R. 421, which would bring in the amount receivable on the sale of trading stock even though that amount is not presently receivable, may be thought to require the anticipation of a profit. In *J. Rowe & Son Pty Ltd* the taxpayer sought to avoid this consequence by arguing for what was called a “profit-emerging” method of accounting in relation to the receivable: the amount receivable would be brought to account only as it became presently receivable. The High Court rejected this method of accounting principally because of the difficulties which arise from the rigidities of trading stock accounting. If the taxpayer sells on credit terms, present receivability and, more so, cash receipt is likely to occur (at least in some degree) subsequent to the year of income in which trading stock ceases to be on hand. It would follow that a deduction of the value of the stock would not be accurately matched with the derivation of income in the form of proceeds of sale. If an item of trading stock is sold in the year in which it is acquired there would be like distortion arising from the allowance of the whole cost as a deduction and the bringing in of only part of the proceeds. The New Zealand High Court decision in *Farmers' Trading Co. Ltd v. C.I.R. (N.Z.)* (1980) 80 A.T.C. 6022 raised the possibility, under a trading stock regime similar to the Australian regime, of bringing in immediately as income an amount of the receivable equal to the value of the item of trading stock shown as an item of opening stock—the value at which the item had been brought to account in the closing stock of the previous year of income—or an amount equal to the amount of its cost if it is sold in the year of acquisition. The balance of the receivable could then be brought to account as income when received on a basis akin to one of the profit-emerging bases referred to in [12.41] above. However the New Zealand Court of Appeal (*C.I.R. v. Farmers' Trading Co. Ltd* (1982) 82 A.T.C. 6001) rejected “profit emerging” of these kinds and adopted the Australian decision in *Rowe*.

12.62 Another possibility would have been to bring in the present value of a receivable when it becomes receivable and to bring in further amounts, in
the same or subsequent years, reflecting the excess of an actual receipt over the amount of the receivable already brought to account. Where provision has been made for a rate of interest to be charged on the receivable, such a present value approach becomes at least awkward. In any case a present value approach raises a question of the treatment of costs. If a present value approach is applied to proceeds, there seems to be equal justification for its application to costs.

12.63 A view that specific profit accounting does not recognise a profit until it is realised has so far been assumed in this Volume. “Profit-emerging” as the applicable method of accounting, on one approach, requires cash receipts of proceeds of sale that exceeds costs. On another approach, profit-emerging will bring in the profit that inheres in a receivable—the excess of the receivable over costs—in the proportion that actual cash receipts bear to the total amount receivable. The latter approach is, in fact, a less than perfect expression of the principle that profit should not be anticipated. The balance of the receivable may never be received, but this is a characteristic of accruals tax accounting that is accepted as consistent with the realisation principle.

12.64 There is however some suggestion in the case law of a kind of profit-emerging accounting applicable to a specific profit that would require the bringing in of an unrealised profit. The suggestion was made by the Revenue in the New Zealand case *H. W. Coyle v. C.I.R. (N.Z.)* (1980) 80 A.T.C. 6012, though the detail of the Revenue's submission does not appear from the report. The case concerned a single venture by a partnership under a contract to roof a power station and clad its walls. The partnership had maintained accounts which reflected what was called a percentage of completion method of ascertaining the profit emerging from the venture. Presumably this method involved an estimate of total expenses that had been and would be incurred in carrying out the contract, and the determination of an estimated profit, being the total of the amounts receivable at any time under the contract, less the estimated expenses. This profit was to be treated as emerging over the years the contract was being carried out in proportion to the amount of the work completed in any year. The amount of the work completed in any year was, presumably, to be determined by reference to the fraction expenses of that year bore to the total estimated expenses. The Revenue's submission was that profit thus emerging in any year should be taxed as income of that year. The partnership accounts did not show the actual monthly progress payments received by the partnership. The method of accounting adopted made them irrelevant. The taxpayer's submission was that the partnership accounts did not express an appropriate method of specific profit tax accounting. The
appropriate method was completion of contract, a method which, it was said, the New Zealand Revenue had accepted in the past. Such a method would have brought in a profit that was income when all the work required by the contract had been completed, if it then appeared that total costs were less than the total of amounts received and receivable. It was not argued that cash receipt of all amounts was necessary. The judgment of Holland J. does not resolve the question of which method of specific profit tax accounting was appropriate. In effect he rejected any method of specific profit accounting and directed that receipts and outgoings accounting should be applied, so that the profit subject to tax in any year would be determined by the deduction of costs incurred in that year and the bringing in of progress payments received in that year. Some statements in his judgment would indicate that specific profit accounting has no place in New Zealand tax law. He drew attention to the New Zealand section corresponding with s. 51(1) of the Australian Assessment Act by which an outgoing is deductible in the year in which it is incurred, with the inference that it cannot enter the computation of a profit that is income in a later year. At the same time be observed (at 6018–9):

“It was conceded to me by counsel for the Commissioner, that if the contract merely provided for one lump sum payment at the completion of the contract, then there can be no argument that no profit was derived until the time for payment became due.”

12.65 The difficulty in accepting the percentage of completion method of determining profit-emerging is that its operation may contradict a principle that would confine a profit that is income to a realised profit. The concession made by the Revenue avoids the contradiction in the circumstances of one payment receivable on completion. In the context of progress payments, profit-emerging confined to realised profit would bring in the surplus of a progress receipt over the expenses in bringing the work to the stage of completion to which the payment relates. At least it would do this if the amount of the receipt does not involve any withholding so that the amount is a fraction of total receipts exactly reflecting the stage of completion. To the extent that there is an element of withholding, the profit treated as emerging is distorted. In the circumstances of progress payments, the receipts and outgoings approach in fact directed by Holland J. brings about additional distortion. The additional distortion is in the failure of matching in the allowance of the deduction of expenses which relate to receipts yet to be derived. Receipts and outgoings accounts will be consistent with a principle requiring realisation only when receipts constantly run ahead of outgoings, and the principle in, *Arthur Murray*
(N.S.W.) Pty Ltd (1965) 114 C.L.R. 314 is applied to the receipts. An illustration is the accounting suggested in [12.56]–[12.58] above as appropriate to the circumstances of New Zealand Flax Investments (1938) 61 C.L.R. 179.

12.66 Where there is an element of withholding in progress payments, a profit-emerging that is consistent with a principle requiring realisation and gives a true reflection of income, will need to adjust the costs that enter the calculation of the profit. There is thus a corresponding deferral of costs.

12.67 Receipts and outgoings accounting does not expressly provide for the anticipation of a loss, save in the election given to the taxpayer by the trading stock provisions referred to in [12.60] above. Receipts and outgoings accounting may have the effect of anticipating a loss where outgoings have been incurred in advance of receipts and no principle of the kind proposed in [11.116]–[11.121] is recognised by which the incurring of an outgoing may be deferred so that there is an incurring of the outgoing as the outgoing is consumed. But this is a fortuitous operation. The loss thus recognised need not to be a loss actual or prospective. It simply reflects the imperfect expression of a matching principle in receipts and outgoings tax accounting.

12.68 Specific profit tax accounting could offer greater scope for anticipating a loss. Thus the percentage of completion profit-emerging accounting proposed in H. W. Coyle Ltd v. C.I.R. (N.Z.) (1980) 80 A.T.C. 6012, could anticipate a loss. There is however no suggestion in the authorities that specific profit accounting will allow or require the anticipation of a loss. It would be assumed that if the market price of land had fallen in Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355 between the inception of the scheme and the sale of any of the developed land, the taxpayer would not have been entitled to any deduction for anticipated loss. A realised loss on the sale of any parcel of land would have been deductible but the loss would have been confined to the loss on that sale.

12.69 The principle that a profit should not be brought to account until it is realised has been considered so far in this discussion as a principle requiring that there be proceeds received or presently receivable in which the profit is to be found. The principle, in another understanding of it, requires that there be proceeds received or presently receivable, and a realisation, in what is another sense of that word, of property that is the occasion of proceeds becoming received or presently receivable. On this understanding of the principle a number of questions call for some consideration:

(i) Where cash or receivable is the proceeds of realisation of property, is the passing
of title in the property necessary if there is to be a realisation?
(ii) Is there a realisation of property when property is exchanged for other property?
(iii) Is there a realisation of property if property is consumed in the acquisition of other property?

12.70 Generally, there will not be proceeds in cash or present receivable unless property has passed. But the passing of property, more especially where the property is land, may be delayed until there has been actual receipt of the whole proceeds of disposition. Delaying the passing of property ought not to prevent the realisation of a profit where there is a contract and there are proceeds in cash or present receivable. At least some equitable interest will have passed and income tax law ought not lightly be made to depend on a distinction between the passing of a legal and the passing of an equitable interest. It will follow that a transaction by which land is sold on deferred payment terms, with the passing of property delayed until all payments have been received, is not to be distinguished from a sale with an immediate passing of property, the payments to be made being secured by a mortgage back to the seller. There will of course be a question whether there has been a receipt by the seller of the whole of the proceeds of sale and a loan back to the buyer, so that profit fully emerges immediately. A construction of a transaction as a receipt and a loan back is open, but there is need to look to the realities of the matter if Permanent Trustee Co. of N.S.W. (1940) 6 A.T.D. 5 is to be followed ([11.129] above). The realities do not show a receipt where it does not appear that the taxpayer could have had a payment from the buyer of money the taxpayer might have retained.

12.71 The question whether there has been a realisation of property where property is exchanged for other assets may be seen as answered by the observations in Smith (1932) 48 C.L.R. 178 that an exchange of assets for other assets is a sale. The issue in the case was whether a dividend could be said to have been paid from a profit from the sale of an asset when there had been a compulsory resumption of property. The conclusion that it had been so paid proceeded on a view that a compulsory resumption is a sale, and in this connection it was said that an exchange of an asset for another asset is a sale. There was no suggestion that the compulsory resumption was not, or that an exchange of assets would not be an occasion of a realisation of a profit. In the case of an exchange of assets, the profit emerges, presumably, when there is a receipt of the asset in exchange, and the amount of the profit will reflect the money value, at the time of receipt, of the asset received in exchange. Section 21 assists this conclusion though it does not fix expressly the time at which the money value is to be determined. Where the asset received is shares whose value is volatile, the
time of valuation becomes especially significant.

12.72 The third question is whether there is a realisation of property if property, for example options, is consumed in the acquisition of other property. The reference to property consumed in the acquisition of other property is intended to identify a transaction distinct from the exchange of an asset for another asset. *Varty v. British South Africa Co.* [1966] A.C. 381 is authority that the exercise of an option is not an occasion of realisation of a profit. There is a distinction to be drawn between the exercise of an option on the one hand, and, on the other, the disposition of the option for cash or in exchange for another asset. There will be a realisation of a profit, that may have been inchoate in the options, on the eventual disposition of the asset acquired in exercise of the options. The circumstances in which the option was held may be such that a sale of the option would have given rise to a profit that was income. The transaction involving the acquisition of property in the exercise of the option may not, however, be such that a profit on the disposition of the property an element that is attributable to the option. is ignored. It is possible, perhaps, to find in the profit on the disposition of the property an element that reflects the profit inchoate in the option at the time it was exercised, or it may be possible to find in the profit on the disposition of the property an element that is attributable to the option. In conditions of rising values the latter would be a greater amount than the former. The difficulties envisaged may suggest that the conclusion in *Varty v. British South Africa Co.* that the exercise of an option is not an occasion of realisation of a profit is not to be followed. Section 21 would assist the calculation of a profit on the exercise of the option. It is, however, assumed that *Varty v. British South Africa Co.* is Australian law.

**The Determination of Profit or Loss on each of Successive Transactions where the Proceeds of an Earlier Transaction is an Item other than Cash**

12.73 *Miranda* (1976) 76 A.T.C. 4180, is authority that rights or options issued by a company to its shareholders are property distinct from the shares in relation to which they are issued. It was not suggested in the case that the rights or options are proceeds of the transaction in which the shares were acquired. If they are seen as proceeds, there is the prospect of finding a realisation of profit in the receipt of the rights or options. In *Miranda* such a profit could not have been held to be income because the case concerned s. 26(a) (now s. 25A(1)) and that section is confined to a profit realised by sale. In other circumstances, however, a profit, if held to be
realised, may be income. The determination of the amount of the profit that
is realised will pose difficulty though not insuperable difficulty. The fall in
the market value of the shares resulting from the rights or option issue will
measure the part of the shares that is realised. If the rights or options are
seen as involving realisation of profit that is income the value at which
they are brought to account in computing the profit must be treated as a
cost in any new transaction involving the rights or options. There will
otherwise be a prospect of two impositions of tax on the one gain.

12.74 An item of property other than cash may be income as a receipt. It
may be a reward in kind for services, or it may be income derived from
property—rent received in kind. In this situation also the value at which the
item is brought to account in the earlier transaction must be allowed as a
cost in any new transaction in which a profit may be realised.

12.75 In Curran (1974) 131 C.L.R. 409 the issue of bonus shares to a share
trader might have been seen, on general principle, as involving a partial
realisation of a profit arising from the shares in respect of which they were
issued. In which event, there would have been a question whether s. 44(2)
precluded such a view being taken. And there would have been other
questions, involving the application of the trading stock provisions which,
it was assumed, applied generally to the share trading activities of the
taxpayer. If a profit that was income had been held to be derived the value
at which the bonus shares were brought to account in computing that profit
would have had to be allowed as a cost in relation to later dealing with
those shares. In fact in Curran the matter was approached only in terms
that the bonus shares might be income derived from property. Barwick C.J.
thought that they were, and that they had been made exempt income by s.
44(2). It followed that the value at which the bonus shares were brought to
account as exempt income had to be allowed as a deduction under the
trading stock provision as a cost of those shares. The consequence would
not be doubted, though the finding that the bonus shares from a capital
profit were exempt income by force of s. 44(2) is a reversion by Barwick
C.J. to the majority view of the interpretation of s. 44(2) in W. E. Fuller
Pty Ltd (1959) 101 C.L.R. 403, a view which had been later rejected in
Gibb (1966) 118 C.L.R. 628. As s. 44(2) was interpreted by Dixon C.J., in
dissent, in Fuller and by the High Court in Gibb in overruling Fuller, a
bonus issue from a capital profit is not exempt income. It is not income and
thus cannot be exempt income. There is, therefore, no exemption to be
protected by allowing deduction of a cost.

12.76 The judgment of Stephen J. in dissent in Curran rejected the
principle adopted by Barwick C.J. Stephen J. was conscious of a
consequence of the rejection: if the bonus issue is made from a revenue
profit there will be two taxes on the same gain—the one on the value of the bonus shares and the other on that value reflected in the proceeds of sale of the bonus shares. That such a consequence will follow from the rejection is a demonstration of the correctness of the principle adopted by Barwick C.J. With respect, the error in the judgment of Barwick C.J. is in the reversion to an interpretation of s. 44(2) that had been rejected by the High Court in Gibb by overruling its own previous decision.

12.77 The principle that requires the allowing of a cost to prevent two impositions of tax on the same gain, or to protect an exemption given to income, is distinct from the principle explained in [12.78]–[12.88] above that where an item of property is “taken into” a process of income derivation, a cost must be allowed of the value of the item at the time it is taken into the process. It is this latter principle that was applied by Gibbs J. in Curran. He saw the bonus shares as a gift by the company to the shareholder, to be treated in the same way as a gift made, for example, by father to son of property which the son then takes into a business of trading in property of that kind. With respect, the principle was misapplied. The bonus shares came to the taxpayer as a consequence of his holding of shares. They arose out of that holding. That they might in some sense of the word be regarded as a “gift” is not to the point. There is no affinity between the receipt of the bonus shares and the act of a taxpayer in taking property, until now held privately, into a business so that it becomes a revenue asset of that business. Nor is there any affinity between the receipt of the bonus shares, and the receipt of property by a taxpayer from another person who, as a private expression of goodwill towards the taxpayer, makes a gift to him of property or sells property to him at less than its value.

The Identification of Cost where Property is Held before a Process of Income Derivation is Entered on, or Property is Acquired Wholly or Partly by way of Gift, or where an Excessive payment is made for Property

12.78 Discussion in previous paragraphs has adverted to the question of identifying cost where property is already held by the taxpayer when it is taken into a process that may yield a profit that is income. In Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355 it was agreed by the parties that in determining the profits realised on disposition of the land, a cost had to be allowed of the value of the land at the time the isolated business venture commenced. The land had previously not been held in any process of income derivation. The principle that is reflected in the agreement in
Whitfords Beach has been accepted in relation to the second limb of the predecessor of s. 25A(1) (s. 26(a)) in *Official Receiver in Bankruptcy (Fox's case)* (1956) 96 C.L.R. 370 and *Bernard Elsey Pty Ltd* (1969) 121 C.L.R. 119. The cost is the market value of the property at the time the item is taken into the business venture or profit-making scheme. The principle would also be accepted when the item is taken into the trading stock of a continuing business carried on by the taxpayer. A view against acceptance of the principle in these circumstances was taken by Barwick C.J. in *McClelland* (1969) 118 C.L.R. 353 at 371 but that view was withdrawn by him in *N. F. Williams* (1972) 127 C.L.R. 226 at 241. In the case of trading stock, there will be an immediate deduction of the value as the cost of trading stock. The principle should also be accepted when the item is taken into a continuing business and becomes a revenue asset though not trading stock of that business.

12.79 The principle reflected in the agreement in *Whitfords Beach* should have an application where property held as a structural asset is taken into a process that may yield a profit that is income as in the New Zealand case *Rank Xerox (N.Z.) Ltd v. I.R.C.* (N.Z.) (1982) 14 A.T.R. 821. In this instance there are other issues raised if the structural asset was one to which the depreciation provisions were applicable, involving the operation of s. 59. The principle should also apply when an asset is transferred from one business or scheme in which it may have yielded a profit that was income to another business or scheme in which it may yield a profit that is income. Issues raised in such circumstances are considered in [12.99]ff. below.

12.80 The principle reflected in the agreement in *Whitfords Beach*, a principle for which, save on some strict view of precedent, the case may be said to stand, should have an application where property is physically taken from other property held by a taxpayer.

12.81 A number of references have been made to the taking and disposal, or the simple disposal in the carrying on of a business of timber, sand, gravel and the like which, until the event, had been part of real property owned by the taxpayer. The references are in [11.271]–[11.272], [2.313]ff., [7.19]ff. above. Some of the cases would suggest that, generally, the value in situ of the property physically taken from the land is not a cost to be brought to account in determining the income from the business. Those cases sit most awkwardly with *Whitfords Beach*. Clearly there are problems in putting a value on the property in situ and in fixing the time at which this valuation is to be made. Where the taxpayer enters on a business operation—a continuing business or an isolated business venture—in the disposal of property physically taken from his land, the cost will be the
value in situ at the time the property was committed to that business. The Federal Court was asked by the High Court to determine the time of commitment in *Whitfords Beach* (1983) 83 A.T.C. 4277. The question of value was left to be settled between Commissioner and taxpayer. Valuation is of course the easier where the whole of the land is to be valued but the greater difficulty where a physical part of the land is to be valued does not justify the abandonment of a principle. The task of valuation is no different from the task of allocating some of the cost of land to a physical part of it when the land is acquired in order that the physical part might be disposed of in the course of business operations.

12.82 There is a specific provision in s. 124J applicable to growing timber acquired and subsequently physically separated from the taxpayer's land. The operation of the provision is the subject of some comment in [11.271]–[11.272] and earlier paragraphs. Where the land was not acquired in contemplation of the disposition of the timber in carrying on a business, the allowance of a deduction of some part of the price paid for the land is obviously inappropriate unless the timber itself is seen as income derived from property (cf. [11.272] above). The deduction should be of the value in situ at the time the land becomes committed to the business. The section provides for the allowance of a deduction of some part of the price paid for land carrying standing timber where “timber is felled in pursuance of a right to fell timber granted by the taxpayer to another person in consideration of payment to be made to the taxpayer as or by way of royalty”. The special significance of the section is in thus allowing a deduction against royalty receipts. The function of s. 124J in this respect has some parallel with the function of s. 27H allowing a deduction of the purchase price of an annuity against receipts under the annuity. A principle asserted in Chapter 2 above (Proposition 4) that an essential element in the notion of income is gain is supported by s. 124J and s. 27H. In other contexts where the item of income is not a specific profit but an item that will be ordinary usage income as a gain derived from property, the principle that an essential element in the notion of income is gain may not be supported. The principle in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 may not extend beyond specific profit tax accounting. A taxpayer who adopts the form of the transaction in *Stanton* (1955) 92 C.L.R. 630 may not derive income in the receipt of the proceeds of the transaction. There may not be a business in the disposing of the property separated from his land. But if there is a business, he will be entitled under the *Whitfords Beach* principle to a cost of the value of the property in situ at the time it became committed to the business. A taxpayer who adopts the form of the transaction in *McCaulay* (1944) 69 C.L.R. 235, will derive income, as
royalties—receipts for the use of his property by another in the taking of
the property separated from his land—and, without the aid of the *Whitfords
Beach* principle, he will be taxed on what is not a gain, save so far as the
circumstances attract the operation of s. 124J, and that section gives
appropriate relief.

12.83 If the *Whitfords Beach* principle is to be extended to circumstances
where there is no business, but the taxpayer's receipts are income derived
from property—royalties arising from the use of his land by another—there
will be a problem of identifying the time when a value that will be a cost of
what is taken from his land is to be determined. The *Whitfords Beach*
principle would suggest that it is the time when the agreement under which
another will take the property is entered into. The operation of the
*Whitfords Beach* principle in a *McCauley* situation will go most of the way
to assimilating the consequences in a *McCauley* situation to those in a
*Stanton* situation, which will, at least, be a sensible outcome.

12.84 Property may be acquired wholly or partly by way of gift, and, in
being acquired, become subject to a process that may yield a profit that is
income. Where the element of gift involves a derivation of income by the
receiver, for example as a reward for services, the principle considered in
[12.74] above, will require that the value of the element of gift be treated
as a cost of the property. A person may sell land to a taxpayer at less than
its market value in order to reward him for some service, and the taxpayer
may acquire with a purpose that attracts the first limb of s. 25A(1). The
element of gift will be an income item derived at the time of the
acquisition. The element of gift must be treated as a cost of the land in
computing a profit on sale of the land by the taxpayer in order that there
should not be two taxes on the same gain.

12.85 There is another reason why the element of gift must be treated as a
cost. The gift may be a pure gift, which is not income. That gift may, in the
very transaction in which it is acquired, be committed by the donee to a
process of income derivation. Treating the value of the gift as a cost is
necessary to prevent it being taxed in the taxing of the proceeds later
arising in the income derivation. The circumstances of *Curran* (1974) 131
C.L.R. 409 were different, and the principle now expressed is no basis for
the conclusion reached by Gibbs J. in that case. The bonus shares were not
acquired and then immediately committed by the receiver to a process of
income derivation. They arose out of the process of income derivation. The
receipt of them was not as yet a derivation of a gain: s. 44(2) precluded
such a conclusion. But sale of the bonus shares would realise a gain. In the
calculation of that gain a subtraction of some part of the cost of the original
shares that were the subject of the bonus issue would be appropriate.
Section 6BA merely states what sound principle requires in any event.  

12.86 The second reason why the element of gift must be treated as a cost is an expression of the principle in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355. The element of gift is treated as a cost in treating the value of the property at the time of receipt as the cost of the property acquired. Clearly an inquiry as to the existence of an element of gift in a transaction by which property is acquired should not be too lightly undertaken. *Jagelden (Weston Hall) Ltd v. Castle* [1969] 3 W.L.R. 839 is authority that the consideration given in an “honest bargain” will determine the taxpayer's cost even though there is some basis for a view that the consideration was less than the prevailing market value of what was acquired.  

12.87 It is a corollary of the *Whitfords Beach* principle that where the price paid for a revenue asset includes an element of donation by the taxpayer who is the buyer, that element of donation should not be treated as a cost. However, the corollary runs against authorities that have been characterised in this Volume as adopting a “form and blinkers” approach to the interpretation of s. 51(1). Those authorities are considered in [9.17]ff. above. Clearly they are relevant where the specific profit accounting is that required by the trading stock provisions, of which s. 51(2) is a part. *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430, and the Privy Council decision in *Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z.) (No. 2)* (1976) 76 A.T.C. 6001 (on appeal from New Zealand) involved the acquisition of trading stock. The authorities may not be directly relevant when cost is not a deductible outgoing, but is brought to account in determining the amount of a profit that is income. At least there is a basis for distinguishing them. But until *Cecil* and *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645 are overruled, they are likely to be extended to the determination of the amount of a cost brought to account in computing a profit that is income. The view of this Volume is that they should be overruled, and an outgoing should not be wholly deductible where its function is in part simply to confer a benefit on another. An inference of such a function may be drawn where the parties are not at arm's length, and there is a clear disparity between the market price and the consideration given.  

12.88 A number of provisions of the Assessment Act are directed to overcoming the operation of *Cecil* and *South Australian Battery Makers* in particular contexts. They are considered in [10.290]–[10.365] above. Section 65 is concerned with any “payment made or liability incurred” that would have been “an allowable deduction”. It cannot have any application to a cost that is not an allowable deduction but enters the calculation of a profit that is income or a loss that is deductible. Sections 82KJ and 82KL
are directed to denying the deduction of a “loss or outgoing”. The significance of the reference to “loss” in those sections is not apparent. None the less, it is clear that the sections can have no application to a cost that is not itself deductible, though it enters the determination of a specific profit that is income or a specific loss that is deductible. Part IVA could apply to deny a tax benefit that would otherwise arise by way of the minimising of a specific profit that is income, or the increasing of a specific loss that is deductible, if a cost that includes an element of gift were to be taken into account in determining the profit or loss.

**Profit or Loss on a Disposition Wholly or Partly by way of Gift**

12.89 The consequences of a disposition of property wholly or partly by way of gift have been explored in the general treatment of specific profit accounting in [12.1]–[12.47] above. Where trading stock provisions are applicable there is a prospect of the operation of s. 36 which may, in effect, bring out a profit or a loss determined by the positive or negative balance of the deemed proceeds of the disposition—the market value of the property—over the cost of the property. Where the item of property is a revenue asset of a continuing business but is not trading stock, the principle in *Sharkey v. Wernher* [1956] A.C. 58 may be attracted to bring about the same consequences. But the authority of *Sharkey v. Wernher* in Australia is not settled. Where the item is property that is the subject of an isolated business venture the reconstruction of the proceeds of disposition and the bringing in of a profit or loss on the basis of the reconstructed profit, must in any event depend on the recognition of an extended *Sharkey v. Wernher* principle. The alternative is that the venture in relation to property disposed of is simply aborted. Where the item is an asset subject to the first limb of s. 25A(1) the gift will abort the transaction, so that no profit or loss that is income or deductible can arise, unless the gift is in a transaction which can be characterised as a sale. There is no express provision of the kind included in s. 36, nor is there any judicially established principle of the *Sharkey v. Wernher* kind that would reconstruct the sale proceeds where the sale is partly by way of gift. Any reconstruction will need to rely on the words “profit arising” in s. 25A(1). Where the item is an asset subject to the second limb of s. 25A(1), a sale is not necessary to attract the operation of the provision. But again there is no express statutory provision or judicially established principle that would reconstruct the proceeds of disposition, and any reconstruction will need to rely on the words “profit arising”. In regard to both limbs the disposition wholly or partly by way of
gift is likely to be seen as a simple abortion, so that no tax consequences involving a profit that is income or a loss that is deductible will follow. Section 26AAA contains an express provision in s. 26AAA(4) such that where property is disposed of by a taxpayer to another person with whom he does not deal at arm's length—which will cover most occasions of a disposition wholly or partly by way of gift—there is a deemed disposition by the taxpayer for the value of the property.

Disposition in Closing down a Business

12.90 Section 36 clearly extends to a disposition of revenue assets in the closing down of a business by a taxpayer, whether a disposition of assets in the transfer of the business to another or a disposition in putting an end to the business. C. of T. (W.A.) v. Newman (1921) 29 C.L.R. 484 treated such dispositions as aborting business operations. Section 36 corrects the consequences of that case where the items of property are trading stock, or property of one of the other kinds to which the section applies. There is no judicial decision that would extend the principle in Newman to other dispositions which are not made in the carrying on of a business. Other dispositions may attract the operation of the principle in Sharkey v. Wernher or an extension of that principle. An extension of the Sharkey v. Wernher principle should displace Newman. Newman, it is considered, should not be followed.

The Consequences of Death of the Taxpayer

12.91 Section 37 of the Assessment Act contains a provision which has an operation in relation to trading stock in the case of the death of a taxpayer, parallel with the operation of s. 36 in the case of a disposition of trading stock not in the ordinary course of carrying on a business. The rigidities of the trading stock provisions explain the need for s. 36. The need for s. 37 is not so evident. In the absence of the section the trading stock would have been shown as still on hand in the deceased's return to the date of death, so that s. 28 would not have operated to allow what is in effect a deduction of the cost of the trading stock. Indeed, it is arguable that s. 37 does not require that the trading stock be treated as not being on hand at the date of death—in which case there would be deemed proceeds to be included in assessable income with no allowance for cost. Escape from such a conclusion will depend on a construction being given to the concluding words of s. 37(1) so that they carry an inference that the taxpayer must be taken to have disposed of the trading stock at the moment of his death.
12.92 Section 37 prevents an abortion of the business operations by the death of the taxpayer. Its operation may be modified by an election under s. 37(2) made unanimously by the trustee of the estate of the deceased and the beneficiaries who are liable to be assessed in respect of the business. If there is an election, the value to be included in the assessable income of the deceased is the value at which the property would have been taken into account at the date of death of the deceased person if he had not died but an assessment had been made in respect of the income derived by him up to that date. There is no express provision which would confine the availability of the election to circumstances where the property becomes an asset of a business carried on by the trustee of the deceased estate. There is such provision in s. 36A(2), applicable to an election where a change has occurred in the ownership of or in the interests of persons in trading stock as a result of the death of a partner.

12.93 Another aspect of s. 37 will prevent an abortion of business operations on the death of a taxpayer where he carried on a business whose revenue assets included standing or growing crops, crop-stools, or trees which had been planted and tended for the purpose of sale. The operation of this aspect may also be modified by an election under s. 37(2). The manner of operation of s. 37 is to include the value of the property in the assessable income, not the profit that may result from a deemed disposition of the property at that value. The assumption, presumably, is that all costs will have been the subject of allowable deductions. But they may not have been, and in that event they would need to be subtracted from the value at death in order to fix a profit. In this respect s. 37 is defective. The taxpayer may himself have acquired as a result of the death of the previous owner, and s. 37(1) will deem the taxpayer to have purchased the property at the value to which s. 37 refers. This deemed cost would not be immediately deductible, though it would be deductible as part of the cost of trading stock if the property is severed by the taxpayer and sold, or if the property is severed by the buyer under the sale. If the taxpayer sells the property unsevered as part of the land, s. 36 will operate and he should be entitled to subtract from the proceeds the cost of acquiring the property. That cost will not have been an allowable deduction: s. 37 in deeming the taxpayer to have purchased the property at its value from the deceased, does not in its terms allow a deduction of that value. In including the value of the property in the assessable income of a person who disposes of it otherwise than in the ordinary course of business, s. 36 suffers from the same deficiency as s. 37.

12.94 Section 37, in deeming the person who acquires from the taxpayer to have purchased at the value given to the property for purposes of the
section, does no more than make more specific the operation of the general principle discussed in [12.78]–[12.88] above, by which property taken into a business operation as revenue assets of that operation has a deemed cost of its value at the time it is taken in.

12.95 There is no section of the Assessment Act that provides generally for a deemed realisation of revenue assets of a business on the death of a taxpayer who conducts that business. And there does not appear to be any judicially created principle. It would be assumed that the principle in *Sharkey v. Wernher* [1956] A.C. 58 could not be extended to this situation. It follows that death simply aborts the business operations.

12.96 The same observations would be appropriate in relation to an isolated business venture, and to transactions otherwise within the first and second limb of s. 25A(1).

12.97 A sale for purposes of s. 26AAA includes the transfer of property from one person to another without consideration (s. 26AAA(1)(f)). A transfer on death may not be included. The inference to be drawn from s. 26AAA(4), by which the Commissioner may treat the transfer as having been made for the amount that in his opinion was the value of the property, is that the notion of sale does not include a transfer on death. It is not a possible description of a transfer on death that the deceased and his estate “were not dealing with each other at arm's length”. It follows that a transaction that might otherwise have been within s. 26AAA is aborted by the death of the taxpayer.

12.98 [11.150]ff. above include a discussion of the operation of s. 101A where property is disposed of by the estate of a deceased taxpayer after the death of the taxpayer and a disposition made during his life would have given rise to a profit that was income. The view there taken is that, despite the wide operation given to s. 101A by the High Court in *Single* (1964) 110 C.L.R. 177, the section would not give an income character to any part of the receipt by the estate on the sale by it of the property. The transaction entered into by the deceased is left aborted by his death. The disposition of the property by his estate may be the conclusion of a distinct transaction by the estate that may give rise to a profit that is income. But the disposition is not the conclusion of a transaction commenced by the deceased and concluded by the estate, by which a profit inchoate in the value of the property at death is realised as income. This interpretation of s. 101A is supported by *Spence* (1967) 121 C.L.R. 273.

The Consequences of Cessation of a Business, or the Taking of Assets out of a Business, or the Transfer of an Asset from one Business to Another
12.99 In [12.89]–[12.90] above the question has been raised whether a disposition of property in putting an end to a continuing business, or a disposition of property in disposing of the business, or a disposition not made in carrying on the business, involves a total or a partial abortion of business operations, so that, in the absence of express provisions of the Assessment Act, no tax consequences attend the disposition. The possible application of an extended *Sharkey v. Wernher* principle was considered, a principle that will treat the disposition as a disposition at market value in carrying on the business. Parallel questions are raised in [12.45]–[12.47] above in regard to an isolated business venture and in [12.48]ff. above in regard to s. 25A(1).

12.100 The question now raised is whether the cessation of a continuing business or of an isolated business venture, generally or in relation to some of the assets of that business, but without any disposition of assets, involves a total or partial abortion of business operations.

12.101 Sections 36 and 37, applicable to trading stock and to some other revenue assets of a business, were noted in [12.89]–[12.98] above. Section 36 requires for its operation that there should have been a “disposal” not in the ordinary course of carrying on the business. If “disposal” is taken to mean disposition, the section has no operation on the occasion of a cessation of business when assets of the business come to be held as private assets, or come to be held as assets of another business or in some other income producing process. The facts of *Sharkey v. Wernher* [1956] A.C. 58 afford an illustration: the horse was taken from the taxpayer's breeding stable conducted as a business, and thereafter was held in the taxpayer's racing stable which was conducted not as a business but as a hobby. The facts involved only a partial cessation of the breeding business. Other facts might be imagined that would involve a total cessation. Another illustration involving partial cessation would be the taking by a dealer of a motor car from his trading stock so that it might be used by him for private purposes. Yet another illustration would be the action of a farmer, who takes an item of livestock as food for himself and his family.

12.102 *Murphy* (1961) 106 C.L.R. 146, though not directly concerned with the issue is consistent only with an interpretation of the word “disposal” that will equate it with disposition, in a sense of disposition which would involve the passing of property at law or, presumably, in equity.

12.103 Section 36 has therefore no operation on the occasion of a simple cessation of business in relation to an asset. However, on the interpretation of the section in *Murphy*, it will have an operation on the subsequent disposition of the asset, at a time when it may be held privately, or be held as an asset of another business, or held in some other process of income
derivation. The fact that disposition may not occur until many years after
the cessation of the business in which the item was trading stock, does not
prevent the operation of the section—a conclusion that is summed up in a
phrase “once trading stock, always trading stock”.

12.104 In the result, s. 36 is a barrier to the adoption in Australian law of
the Sharkey v. Wernher principle in its application to an occasion which
does not involve the disposition of property. And, in any case, s. 36 must
come into collision with principles that seek to determine the consequences
of disposition of an asset by reference to the circumstances of its holding at
the time of the disposition. At the time of its disposition, the asset that was
trading stock in the old business, may have come to be held in a new
business, or in an isolated business venture, or in a transaction that
involves the operation of s. 25A(1). When taken into the new business or
business venture, or into the s. 25A(1) transaction, the asset must be given
a cost of its value. If it is trading stock of the new business, the cost will be
deductible though in effect deferred until the item is disposed of—when it
becomes an item no longer “on hand”. The proceeds of disposition will be
income. If the item is not trading stock of the new business but is a revenue
asset of that business, or is an item now subject to an isolated business
venture, the cost will be subtractable in determining the profit that is
income on the realisation of the item. The cost will be subtractable in
determining the profit that is income in the s. 25A(1) transaction. But the
hanging fire of the operation of s. 36 in relation to the asset because it was
trading stock of the old business must in some way be accommodated. As
interpreted in Murphy, s. 36 requires that the value of the item on the
occasion of its disposition in the new business, business venture or
transaction, must be brought to account as assessable income. A
disposition in the new activity could not be in the ordinary course of the
old business. There will, presumably, at this time be an operation of s. 28
in relation to the old business, so that the cost of the item in that business
now becomes deductible. A conclusion that s. 28 operates in this way was
assumed in Murphy, though it is curious that an item must be regarded as
still “on hand” in the old business, though that business ceased a number of
years previously. The correlation of the operation of s. 36 and s. 28 in the
old business, with the operation of the trading stock provisions in the new
business or specific profit accounting in the new business, business venture
or s. 25A(1) transaction, can only be on some arbitrary basis that would
select one regime and reject the other.

12.105 The tax consequences of the action of the farmer who takes an item
of livestock as food for himself and his family are, it seems, fixed by the
Commissioner on a basis that assumes s. 36 is not applicable. The practice
is to bring in an amount in respect of the item being the value at which the item was shown as stock on hand at the beginning of the year of income, or its cost of purchase if it was purchased during the year. The effect is to offset the allowance of a deduction in respect of the item which is no longer “on hand”, though it has not been and now can never be “disposed of” so as to attract the operation of s. 36. The practice recognises an abortion of the process of income derivation in relation to the stock. It leaves the farmer, however, with those deductions, already effectively allowed, which relate to the stock but would not have entered the determination of the value of the stock on hand. Where the item of livestock is natural increase, its cost price is fixed by regulation at an arbitrary low figure, so that the deductions relating to the item that are effectively allowed will be substantial. The consequence is a special subsidy to production for one's own consumption.

12.106 The case for adopting the principle of Sharkey v. Wernher [1956] A.C. 58, at least in an application to cessation of business and to ceasing to hold assets in a business, is compelling. A conclusion that there is a “disposal” in these circumstances for purposes of s. 36 is not expressly rejected in Murphy (1961) 106 C.L.R. 146. The question was not raised. If the conclusion were to be accepted, s. 36 would cease to be a barrier to the adoption of the principle. But it would be no more than a partial confirmation of it. The principle should be adopted with as wide an operation as possible. And it should have no less operation in regard to isolated business ventures and s. 25A(1) second limb transactions, than it may be allowed in regard to continuing business situations.

12.107 The adoption of the principle will, it is true, raise issues as to when a business or business venture or profit-making scheme may be said to cease, and as to when an asset may be said no longer to be an asset held in a business, business venture or scheme. Ferguson (1979) 79 A.T.C. 4261 is the subject of some comment in [2.440] above. The views expressed in the Federal Court in that case would draw a distinction between a preliminary business of building up a herd of cattle under arrangements for breeding and agistment, and a later business of being a grazier. The proposed Sharkey v. Wernher principle would operate on the change from the one business to the other.

12.108 There is good reason to extend a Sharkey v. Wernher principle not only to the cessation of business and the movement of an asset out of a business, but also to the movement of an asset within a business from a holding where it has the character of a revenue asset to a holding where it has the character of a structural asset. If a taxpayer who deals in motor vehicles takes a vehicle from his stock and uses it as a demonstrator, s. 36
or *Sharkey v. Wernher* should operate to bring about a deemed realisation at market value. The cost for purposes of depreciation on the demonstration vehicle will be that value.

**The Determination of Profit or Loss on Successive Transactions in Shares and Rights to Shares**

12.109 A consideration of the determination of profit or loss on transactions in shares and rights to shares may assist an understanding of the variations in tax accounting that will arise depending on what set of principles or specific statutory provisions apply to a transaction. It will also serve to introduce some aspects of trading stock accounting: a share, or a right to or option over a share, may be held in a way that makes it trading stock of a business and the accounting provided for in ss 28ff. becomes applicable. In its effect, trading stock accounting is accounting for profit or loss, though the consequences of its operation may differ in a degree from the consequences of the operation of other principles or specific provisions by which a profit or loss in a transaction in shares may be determined.

**Where there is no rights or bonus issue in respect of shares held by the taxpayer**

12.110 For the purposes of the following discussion, this example will be considered: the sale of land by a company that is a dealer in land to a company that is engaged in land development. Part of the consideration is a number of options over shares in the development company. The remainder of the consideration is cash. The exercise price under the options is the market value of the shares at the time of sale of the land. The market value of the shares increases steadily over a period of time during which the land dealing company sells some of the options, exercises the remaining options and disposes of the shares thus acquired. It disposes of the shares acquired in the exercise of the options in response to a share exchange takeover bid. It is assumed that the land dealing company—the taxpayer—has not engaged in any other transaction involving shares.

12.111 There is an immediate question of the accounting applicable to the sale of the land. The possibility is explored in [12.69]ff. above that the time of realisation of the land, at which a profit will normally be determined, is the time of the contract of sale, and not the time of completion of the contract by conveyance. The proceeds of sale that will be income under the trading stock provisions, will include the amount of cash receivable under the contract. Trading stock accounting, in this context an aspect of accruals accounting, is clearly applicable to the taxpayer as a dealer in land. *J. Rowe*
& Sons Pty Ltd (1971) 124 C.L.R. 421 requires that an amount receivable in cash even though it is not immediately receivable will be treated as income derived at the moment of realisation of the asset.

12.112 The options may be differently treated. The view was expressed in [11.57]ff. and [11.148] above that, where consideration is property other than cash, derivation will not occur until all steps have been taken, having regard to the nature of the property, to vest it in the taxpayer. This, it would be asserted, is the test of derivation irrespective of whether the taxpayer is on accruals or cash in relation to the transaction, and irrespective of whether or not the item is trading stock. It would follow that there is no derivation of the options until there is an issue of options to the taxpayer by the purchasing company. In determining the amount that is to be brought to account as assessable income of the taxpayer, the options will be given a value, not at the time of the contract, but at the time of issue of the options. There is thus some prospect that the policy sought to be achieved in J. Rowe & Son Pty Ltd (1971) 124 C.L.R. 421—that there should be a derivation of all the consideration on the sale of trading stock at the time the stock ceases to be on hand—will be defeated. The issue of the options may be delayed until a year of income subsequent to the year in which the land was sold.

12.113 The value of the options will reflect the exercise price, the period during which the options are exercisable and the anticipated movement in the value of the shares during that period. The value of the options on the facts assumed may be small since the exercise price is the value of the shares in the development company at the time of the contract of sale, though valuation will need to take into account the period of time within which the options are exercisable. The value that will be brought to account will not, it seems, be affected by an inside knowledge of the affairs of the land development company which the taxpayer might have. Section 21 and general principles require that the market value be brought to account, not the “value to the taxpayer” which might be greater or might be less. Section 26(e), which would bring in the value to the taxpayer, has no application because the options are not a reward for services rendered by the taxpayer (Cooke and Sherden (1980) 80 A.T.C. 4140).

12.114 Accounting in relation to any transaction involving the sale of the options, or the exercise of the options and the sale of the shares, will depend on the character that the options assume in the hands of the taxpayer. The options will have the character of trading stock if they are seen as land, held in another form, but indistinguishable in principle from the other land in which the taxpayer deals. They will equally have the character of trading stock if they are seen as the first stock acquired of a
business of dealing in options and shares. The first possibility is the more likely. If the options have the character of trading stock there will be a deduction of their cost, which in these circumstances is the amount at which they are brought to account as income on the sale of the land. The taxpayer must be taken to have sold the land for an amount that includes the value of the options, and to have outlaid the amount of the value of the options in acquiring the options. This amount will be a deduction in the year of acquisition of the options, and will be included in the value of closing stock at the end of the year, if the options have not been dealt with before the end of the year, and no election has been made to value the options otherwise than at cost. Trading stock accounting is more closely explained in Chapter 14 below. The options may not have the character of trading stock but may, none the less, be revenue assets. This may be the more appropriate characterisation of the options when their acquisition is incidental to the carrying on of a business. In *Jennings Industries Ltd* (1984) 84 A.T.C. 4288 shares were acquired by the taxpayer in a company that would let a building contract to the taxpayer, a contract from which the taxpayer might profit. A sale of the shares thereafter by the taxpayer was contemplated, but was not a definitive intention. The Federal Court held that the “profit” from a sale of the shares was income. The events were seen as an extension of the taxpayer's business activity of acquiring land, its development by erecting buildings, and the sale of the land.

12.115 There is some basis for a conclusion that the options will be revenue assets if it was not commercially open to the taxpayer to receive the value of the options in cash from the land development company. The matter is discussed in [12.188] below. In these circumstances the options will have the same character as a right to receive payment in cash as proceeds of sale of trading stock would have. They will have an attributed cost equal to the amount of the notional cash receivable. There will be no deduction of an attributed cost of the options and there will be no present tax accounting. But the attributed cost will be brought to account, on the realisation of the options, in determining the amount that is a profit that is income, or a loss that is deductible.

12.116 There are other possible characterisations of the options. They could conceivably be assets acquired in an isolated business venture, being the acquisition of the options, their exercise and the sale of the shares. The judgment of Jacobs J. in *Macmine Pty Ltd* (1979) 53 A.L.J.R. 362, in treating the exercise of options and the sale of shares as no more than an advantageous realisation of the options, does not dictate a conclusion that an operation that includes the acquisition of the options with a purpose to exercise them and sell the shares is not an isolated business venture. If the
operation is treated as an isolated business venture, there will be a prospect of tax accounting on completion of the venture but no present accounting. The cost of the options, for this purpose, will be an amount equal to the amount at which they were brought to account as proceeds of the sale of the land.

12.117 If the options are none of trading stock, revenue assets or assets held in an isolated business venture, they may yet be assets to which the first limb of s. 25A(1) applies. On the authority of the statements made by Gibbs C.J. and Mason J. in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355, a characterisation as a s. 25A(1) assets is only open if none of the other characterisations is appropriate: s. 25A(1) is applicable only when the asset is not held in circumstances that may yield income by ordinary usage. If s. 25A(1) applies there will be a prospect of tax accounting on a sale occurring but no present tax accounting. Again the cost of the options will be the amount at which they were brought to account on sale of the land.

12.118 The options may be assets to which the second limb of s. 25A(1) applies. They cannot be such is they are trading stock, revenue assets or assets held in an isolated business venture. The statements of Gibbs C.J. and Mason J. are again relevant. If the second limb applies, there will be a prospect of tax accounting on the arising of a profit in carrying out the undertaking or scheme, but no present tax accounting. Cost will be determined as in the first limb transaction.

12.119 The options may not be assets to which s. 26AAA could be applicable. They cannot be such if they are trading stock, revenue assets or assets held in an isolated business venture (s. 26AAA(5)). The applicability of s. 25A(1) does not however preclude the operation of s. 26AAA, though distinct and cumulative amounts cannot be included in income by the operations of both s. 25A(1) and s. 26AAA. However, s. 26AAA seems not to be applicable to the options. The inference to be drawn from paras (d) and (e) of s. 26AAA(1) is that giving value for the creation of a right is not a purchase of that right for purposes of s. 26AAA(2).

12.120 The taxpayer may sell the options. If the options are trading stock, the proceeds of sale will be income, and the value of the options as opening stock of the year of sale, if they were acquired in a previous year, will in effect become deductible. The options will not be any longer on hand. If they are revenue assets, a profit determined by the excess of the proceeds of sale over the attributed cost of the options will be income. A loss would be deductible, but the assumption of a steady increase in the value of the shares would in fact exclude the possibility of a loss. If the options are assets to which the first limb of s. 25A(1) applies, a profit determined in the same way as for a revenue asset will be income.
12.121 Instead of selling the options the taxpayer may exercise them and acquire shares. The question now raised is whether the exercise of an option is the realisation of that option, so that there may be an item of income or loss deduction then arising. *British South Africa Co. v. Varty* [1966] A.C. 381 is authority that the exercise of an option is not a realisation. It will follow that there are no proceeds that will be income on the exercise of options that are trading stock. It does not necessarily follow that the options remain “on hand” so that the cost or other value of them must continue to be deferred by the operation of s. 28. Yet it would distort the operation of the trading stock provisions to hold that the options are no longer on hand. A rational view of the operation of the provisions would treat the options as still on hand in the form of the shares into which they have been converted, and the shares as having a cost which includes the attributed cost of the options. The shares are treated as having been acquired in a two step transaction.

12.122 The exercise of the options would not be a realisation of a revenue asset, or a realisation that will require the striking of a profit if there is an isolated business venture. And, presumably, the exercise of the options would not be an event on which a profit arises for purposes of the second limb of s. 25A(1). If the exercise of the options is not a realisation of them, it is, a fortiori, not a “sale” of them within the meaning of that word in s. 25A(1). There will not therefore be any accounting on the exercise of the options if they are s. 25A(1) first limb assets.

12.123 The questions now raised concern the character of the shares acquired in the exercise of the options. The shares will presumably be trading stock if the options are trading stock. Alternatively, the shares may be revenue assets as assets acquired in what is, as yet, the incomplete process of realising the options that are revenue assets.

12.124 If the shares are trading stock or revenue assets, they will not be assets subject to the operation of s. 25A(1) (*Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355). And they will not be assets subject to the operation of s. 26AAA (s. 26AAA(5)). If they are not trading stock or revenue assets, they may be s. 25A(1) first limb assets. If they are s. 25A (1) first limb assets, their cost for purposes of the calculation of the profit that is income on the sale of the shares will depend on the analysis of the s. 25A(1) transaction. On one analysis the exercise of the options was an abortion of a transaction which involved the acquisition of the options for the purpose of profit-making by sale. It will follow that the exercise of the options is the first and only step in the acquisition of the shares for profit-making by sale, so that the cost of the shares must include both the amount paid on exercise of the options and the value of the options at the time of
their exercise (*Executor Trustee & Agency Co. of S.A. Ltd* (*Bristowe's case*) (1962) 36 A.L.J.R. 271. Another analysis will involve a lower cost. This analysis would treat the acquisition of the options and their exercise as steps in the acquisition of the shares for resale at a profit. It will follow that the cost of the shares is the value of the options at the time they were acquired, and the amount subscribed in the exercise of the options. The possible distinction between a one step acquisition and a two step acquisition is drawn by all members of the High Court in *Steinberg* (1975) 134 C.L.R. 640.

**12.125** There is yet another analysis that would exclude the operation of the first limb of s. 25A(1) by treating the acquisition of the shares, albeit for resale at a profit, as a step in the advantageous realisation of the options. This would follow the analysis adopted by Jacobs J. in *Macmine Pty Ltd* (1979) 53 A.L.J.R. 362 which is the subject of comment in [3.68] above.

**12.126** There will remain the possibility of the application of the second limb of s. 25A(1), or of s. 26AAA. The operation of the second limb of s. 25A(1) requires that the acquisition of the options and the exercise of the options be treated as steps in the carrying out of a profit-making undertaking or scheme. Treating the acquisition of the options and their exercise in this way will have to reject a view that any scheme was aborted by the exercise of the options, the scheme being a scheme to acquire the options and sell them. The view of Barwick C.J. in *Steinberg* (1975) 134 C.L.R. 640 that all details of a scheme must be formulated at the time of acquisition would exclude a view that there was simply a variation within a more general scheme to profit, and such an adjustment did not give rise to an abortion. If there is a scheme within the second limb of s. 25A(1), the costs of the shares that will enter the calculation of any profit that arises will be the value of the options at the time of exercise and the amount paid on the exercise of the options. The amount of profit that is income if s. 26AAA applies will thus be less than the profit that may arise under the second
limb of s. 25A(1).

12.128 The final event in the assumed series of events is the disposition of the shares in response to a share exchange takeover bid. If the shares are trading stock there is presumably a realisation. British South Africa Co. v. Varty [1966] A.C. 381 would support such a conclusion. The value of the shares received in exchange would be proceeds of realisation. Questions of the precise time of the realisation, considered above in relation to the realisation of the land, will arise. The amount of proceeds may be different if the amount is to be determined at the time of issue of the shares received in the takeover, and not at the time of the acceptance of the takeover offer. The time of issue of the shares is the appropriate time.

12.129 If the shares are revenue assets or assets of an isolated business venture, like questions will arise as to the fact of realisation and the moment when realisation occurs. If the first limb of s. 25A(1) is applicable, the issue is whether the share exchange is a sale. There are observations in Smith (1932) 48 C.L.R. 178 that would support a view that the exchange is a sale.

12.130 The share exchange will be a sale for purposes of s. 26AAA (s. 26AAA(1)(f)), and if s. 26AAA is otherwise applicable there will be an operation of the section. The exercise of the options, involving a subscription of capital, is a purchase (s. 26AAA(1)(d)). The profit will be calculated by subtracting the value of the options at the time of their exercise and the amount paid on their exercise. The profit will then be less than the profit in the s. 25A(1) two stage acquisition situation.

12.131 The complexity of the analysis required in relation to a relatively simple fact situation is the consequence of general principle and specific statutory provisions tending to converge. In some circumstances a moment of realisation will attract more than one basis on which a profit is income. Where it does, there are not several profits all subject to tax. But the Commissioner is presumably entitled to treat as income the highest profit that any applicable basis will yield.

Where there is a rights or bonus issue in relation to shares held by the taxpayer

12.132 The fact situation considered in previous paragraphs does not involve a rights or bonus issue. The tax accounting, if there is such an issue as an aspect of a transaction in shares, requires separate consideration. The tax accounting applicable to transactions in shares when there is a rights or bonus issue in relation to the shares will depend on the manner of the holding of the shares: whether they are held in circumstances which attract the operation of s. 25A(1) or s. 26AAA or of the ordinary usage concept of
income. Within the ordinary usage concept they may be held as trading stock of a continuing business as in *Investment & Merchant Finance* (1971) 125 C.L.R. 249, or they may be held as revenue assets though not trading stock, of a continuing business. Illustrations of the latter are afforded by the view of the facts taken by Gibbs J. in *London Australia Investment Co.* (1977) 138 C.L.R. 106 and by the banking and life insurance cases ([2.455]ff. above).

12.133 In the following account of the applicable tax accounting ss 25A(1) and 26AAA situations are dealt with first, in order that contrasts might be drawn when dealing with the operation of ordinary usage principles. It is assumed, however, that where there is a continuing business, s. 25A(1) will have no application: this is to adopt the view of Gibbs C.J. and Mason J. in *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355. It is also assumed that where there is a continuing business, s. 26AAA has in general no application: s. 26AAA(5)(a) excludes the operation of s. 26AAA where the property sold was “included in the assets of a business carried on by the taxpayer and, as a result of the sale, an amount will be included in the assessable income of the taxpayer of the year of income under a provision of [the] Act other than [s. 26AAA]”. It is also assumed that a rights issue (which would include an options issue) and a bonus share issue, made in relation to a taxpayer's shares, are not income of the taxpayer as dividends under s. 44(1), or within an ordinary usage notion of a dividend. The discussion in [2.247] above is relevant. And it is assumed that a rights or bonus issue is not proceeds of realisation of the shares held by the taxpayer in relation to which the issue is made. The discussion in [12.73] and [12.75] above is relevant.

12.134 There is, at least in theory, a possibility that, because of the operation of the principle in *Curran* (1974) 131 C.L.R. 409 to a rights issue in a continuing business situation, involving revenue assets that are not trading stock, ordinary usage business income principles may give rise to a loss and for this reason s. 26AAA(5)(a) will not operate to exclude the operation of s. 26AAA. The situation envisaged would involve the exercise of rights and the sale of shares. The simple sale of the rights acquired in a rights issue will not attract the operation of s. 26AAA since there is no purchase. But a sale of shares acquired in the exercise of rights in a continuing business situation may prima facie attract the operation of s. 26AAA to bring in a profit and may give rise to a loss on ordinary usage principles, at least as those principles are understood by Gibbs J. in *Curran*. Since there is no profit on ordinary usage principles, the possibility of the operation of s. 26AAA to give rise to a profit that is income is raised. The possibility would depend on the amount of cost
attributable to the rights that are exercised in the deemed purchase of the
shares sold within 12 months. That cost is presumably the value of the
rights at the time of their exercise, which may be different from the cost
attributable to the rights in the operation of the ordinary usage business
principles which is their value at the time of issue. The competition
between a loss deduction under ordinary usage principles and a profit
under s. 26AAA would, presumably, be resolved in favour of bringing in
the latter.

12.135 The applicability of ordinary usage principles will almost
invariably exclude s. 26AAA if the shares and rights are trading stock. In
that event, save where the shares or rights are valueless, there will be an
amount to be included in assessable income on sale: the trading stock
provisions of the Assessment Act include in assessable income the whole
of the proceeds of sale.

12.136 There is nothing in s. 26AAA(5) that will exclude the operation of
s. 25A(1). Where s. 25A(1) will give rise to an amount of assessable
income, the Commissioner may include that amount notwithstanding that s.
26AAA would yield a lesser amount. And the Commissioner may include
an amount under s. 26AAA, even though it is greater than the amount that
would be included under s. 25A(1).

12.137 Subsections (2)–(12) of s. 25A(1) include a number of provisions
which extend the operation of s. 25A(1). One of these, s. 25A(4), deems
bonus shares and rights, the issue of which is attendant on shares that were
acquired for profit-making by sale, to have themselves been acquired for
profit-making by sale, thus overcoming Miranda (1976) 76 A.T.C. 4180.
Another provision, s. 25A(5), will deem the transferee of property where
the property was acquired by the transferor for profit-making by sale,
himself to have acquired for profit-making by sale, if, for example, the
property was transferred to him by way of a gift or for less than an arm's
length price. Some reference is made to these provisions in the discussion
of tax accounting that follows. The tax accounting implications of these
provisions are considered more closely in Chapter 3 above. It is assumed
that all the provisions of s. 25A(2)-(12), like those of s. 25A(1), are
applicable only when the ordinary usage principles in relation to business
income are not attracted. Whitfords Beach Pty Ltd (1982) 150 C.L.R. 355
is taken to be authority.

12.138 The model facts assumed in the following discussion are an
acquisition of shares—“the original shares” and:

(1) a sale of some original shares;
(2) the issue of rights attendant upon some of the original shares, and the sale of
those rights;
(3) the issue of rights attendant upon some of the original shares, the exercise of those rights and the sale of the new shares;
(4) the issue of bonus shares attendant upon some of the original shares and the sale of those bonus shares;
(5) the disposal of original, new and bonus shares in response to a share exchange offer; and
(6) the disposal of original, new and bonus shares in response to a share exchange offer and the sale of shares received in exchange for original, new and bonus shares.

The operation of section 25A

12.139 A sale of original shares will attract the operation of s. 25A(1) where they were acquired for profit-making by sale. There is a question of the cost of the original shares so sold where they are sold subsequent to a bonus issue or a rights issue attendant upon those shares. The Commissioner is empowered by s. 25A(10)(e) and by s. 6BA(3) to apportion the cost of the original shares between those shares and the bonus shares. The apportionment is made as the Commissioner considers appropriate in the circumstances. The effect of the exercise of the power is that the cost of the original shares will be less, and the profit that is income on the sale of the shares will be greater or the loss that is deductible under s. 52(1) will be less. There will presumably be no room for the operation of s. 52A, so as to empower the Commissioner to decline to take into account some part of the cost of the original shares in determining the profit or loss on their sale. Section 52A is applicable only where shares are acquired as trading stock or in the carrying on or carrying out of any profit-making undertaking or scheme, or are treated or used as assets of a business or in the carrying out of a profit-making undertaking or scheme. It is assumed that none of those circumstances exist in relation to the original shares.

12.140 The Commissioner has no power under s. 25A(10)(e) and s. 6BA to apportion the cost of the original shares between those shares and the rights that have been issued attendant upon those original shares. For reasons explained in the last paragraph, the Commissioner has no power under s. 52A to decline to take into account some part of the cost of the original shares in determining the profit or loss on sale of the original shares. In the result the profit on the original shares that is assessable income will be limited or the loss deduction inflated by the making of a rights issue.

12.141 Rights issued attendant upon the original shares will be brought within the operation of s. 25A(1) by s. 25A(4). The rights will be deemed to have been acquired for the purpose of profit-making by sale and to have been acquired at no cost (s. 25A(10)(d)). In the result the whole amount for
which the rights are sold will be assessable income. There does not appear
to be any function for the Commissioner to perform under s. 25A(9), which
gives him power to determine the amount of the proceeds of sale that is
deemed to be the profit arising from the sale of the rights. The provisions
of s. 25A(10)(d) are mandatory. There is no transfer of any part of the cost
of the original shares to the rights, and in this respect the treatment of
rights received by the taxpayer in a rights issue and sold by him differs
from the treatment of bonus shares received and sold. It is appropriate that
s. 52A has no application in relation to the cost of the original shares: a
reduction by the Commissioner of the cost of the original shares under s.
52A, if it did apply, would produce an unfair outcome.

12.142 If the rights are not sold, but are exercised so that shares are
acquired and those shares are sold, s. 25A(1) may be attracted by an actual
acquisition of the shares for profit-making by sale. But there will not be a
deemed acquisition for profit-making by sale. The deeming by s. 25A(4) is
confined to the rights and does not extend to shares acquired in exercise of
the rights.

12.143 The taxpayer will carry the onus of showing that the shares were
not acquired for profit-making by sale, but that onus might be discharged.
And the conclusion may be drawn, in line with the judgment of Jacobs J. in
Macmine Pty Ltd (1979) 53 A.L.J.R. 362, that an acquisition and sale of
the shares is not within the first limb of s. 25A(1), because it is simply an
advantageous realisation of the rights. If the first limb of s. 25A(1) is
applicable in relation to the acquisition of the shares by exercise of the
rights, there will be a question whether s. 25A(10)(d) applies to limit the
cost of the shares to the amount paid in subscribing for the shares. That
paragraph in its terms deems the rights to have been acquired at no cost,
but this deeming is only for the purpose of determining the profit on the
sale of property deemed to have been acquired by the taxpayer for profit-
making by sale. It would be argued that s. 25A(10)(d) does not exclude the
giving of a value to the rights which will be part of the cost of the shares,
following the analysis in Executor, Trustee & Agency Co. of S.A. Ltd

12.144 There is a possibility that subs. (6) of s. 25A will apply so that the
sale of the shares acquired in exercise of the rights is deemed to be a sale
of property acquired for the purpose of profit-making by sale, as property
in which rights deemed to have been acquired for profit-making by sale
have merged. The Commissioner would then, by the operation of subs. (9),
have a power to fix a profit that is income. In the exercise of his function
he is required by subs. (10)(c) to have regard to the extent to which the
shares consist of or are attributable to the rights. The application of s. 25A
(6) is doubtful. It was inserted to deal with merger of interest situations such as in McClelland (1970) 120 C.L.R. 487 and A. L. Hamblin Equipment Pty Ltd (1974) 131 C.L.R. 570. The exercise of rights is not easily described as a merger of the rights in the resulting shares. In any case there is nothing in subs. (6) that would require that the value of the rights at the time of the exercise should not be treated as a cost of the shares. It is true that s. 25A(10)(d), on a sale of the rights, requires that the rights be treated as having no cost. But there is no provision of s. 25A that makes the sale of shares a sale of rights exercised in acquiring the shares. In the result there would appear to be some advantage to be gained by the exercise of rights and sale of the resulting shares, rather than selling the rights.

12.145 Where bonus shares attendant upon the original shares are issued they will be deemed by s. 25A(4) to have been acquired for profit-making by sale and s. 6BA is expressly attracted by s. 25A(10)(e). Section 6BA will have the effect of transferring some of the cost of the original shares to the bonus shares and of denying that any part of the moneys paid up on the bonus shares in the process of their issue is a cost to the taxpayer of the bonus shares, save where the bonus shares are assessable income and the taxpayer is not a company (s. 6BA(2) and (4)). The denying of cost by s. 6BA(2) will operate save where the moneys paid up have been or will be included in the assessable income of the taxpayer and the taxpayer is not a resident company (s. 6BA(4)). Section 25A(10)(e) taken with s. 6BA, is directed to overcoming the principle in Curran (1974) 131 C.L.R. 409 in its possible application to bonus shares deemed to have been acquired for profit-making by sale. The bonus shares may be sold in a transaction not at arm's length for an amount that is less than their value, so as to bring about a loss. The loss will not, however, be deductible. Deductibility is excluded by s. 52: it is not expressly allowed by s. 52(2), and is denied generally by s. 52(5)(a).

12.146 The taxpayer may dispose of some of the original shares or bonus shares in response to a share exchange takeover bid. Two questions arise: the first is whether a share exchange involves a sale and the second concerns the amount of the proceeds of such a sale that will enter the determination of the profit arising. The answer to the first question may be found in the judgment of Rich J. in Smith (1932) 48 C.L.R. 178 at 186: “Sale is not a word of precise technical import. In many contexts the essential idea it conveys is an agreement to transfer property for a valuable consideration”. The essential idea would embrace a transfer of shares in response to a share exchange takeover bid. The answer to the second question is presumably afforded by s. 21: the money value of the shares
received in exchange is deemed to have been received by the taxpayer.

12.147 On the sale of the shares acquired in exchange for the original or bonus shares, there will be an operation of s. 25A only if the acquisition was an acquisition with an actual purpose of profit-making by sale. There is no deeming arising from these circumstances. The shares acquired will have a cost equal to their value at the time of acquisition—the value brought to account in determining the profit on the transfer of property in the original or bonus shares. The original or bonus shares must be taken to have been sold for an amount equal to the value of the shares taken in exchange and the shares taken in exchange to have been acquired for an amount equal to that value.

The operation of s. 26AAA

12.148 A sale of original shares will attract the operation of s. 26AAA where they were purchased within 12 months of the sale. “Purchase” and “sale” have extended meanings attributed to them by s. 26AAA(1). The amount of any profit will be income but a loss will not be deductible. Where the profit is greater than the profit that is income under s. 25A(1) and that section is applicable, the Commissioner is entitled to insist on the inclusion of the greater amount. The profit that is income under s. 26AAA may be greater because of the operation of s. 26AAA(4) which will attribute proceeds of sale equal to the price that would have been received in an arm's length transaction. The amount of s. 25A(1) income may be less than the amount of s. 26AAA income because the former is calculated by reference to the actual sale price which, it is here assumed, is less than the arm's length price. There will however be the prospect under s. 25A(5) of a further derivation of assessable income by the transferee of the original shares when he sells.

12.149 Section 25A(5) deems the transferee to have acquired for profit-making by sale, where he acquired from a person who had acquired the property for profit-making by sale, and acquired it in a transfer not at arm's length by way of gift or for a consideration less than the amount considered by the Commissioner to be the value of the property immediately before the transfer. When the transferee sells the Commissioner is empowered by s. 25A(9) to determine the amount of the profit then derived by the transferee. In determining that profit the Commissioner is required to have regard to the matters specified in subs. (10). Any expenditure by the transferee in acquiring the property is to be disregarded. The transferee takes the transferor's costs and is entitled in effect to a further cost of the amount of any profit included in the income of the transferor in respect of
the transfer of the property. Profit, for this purpose, would presumably include profit that is income of the transferor under s. 26AAA. In the result double tax of the amount by which the transferor's profit under s. 26AAA exceeds his s. 25A(1) profit is avoided.

12.150 There is a question of the cost of the original shares for purposes of s. 26AAA where they are sold subsequent to a bonus issue or a rights issue attendant upon those shares. The question will be answered in the same manner as the like question considered in [12.139]–[12.140] above in relation to the operation of s. 25A(1). Again, there will be no room for the operation of s. 52A so as to empower the Commissioner to decline to take into account some part of the cost of the original shares in determining the profit on their sale.

12.151 Section 25A(1) and s. 52(1) in the circumstances of the sale of the original shares may give rise to a loss that is deductible. Section 26AAA cannot give rise to a deductible loss.

12.152 Where there has been a rights issue attendant upon the original shares and the rights are sold, the sale will not attract the operation of s. 26AAA. There has not been a purchase within the meaning of that word in s. 26AAA. The deeming by s. 25A(4) is not relevant to s. 26AAA.

12.153 If the rights are not sold, but are exercised so that shares are acquired and those shares are sold, s. 26AAA may be attracted. There will be a purchase of the shares in the subscription for the shares (s. 26AAA(1)(d)) and the cost should include both the amount paid by way of subscription and the value of the rights at the time of the subscription. Section 26AAA cannot give rise to a loss. Where both s. 25A(1) and s. 26AAA operate to produce a profit that is income, the Commissioner may include the greater amount in the taxpayer's income.

12.154 Where bonus shares attendant upon the original shares are issued there may be a deemed purchase under s. 26AAA(7). The provision is primarily directed at determining the time of purchase of the bonus shares. But it seems also to deem the acquisition of the bonus shares to be a purchase of them. The cost of the bonus shares for purposes of determining the profit that is income will be the amount of cost transferred from the original shares by the Commissioner acting under s. 6BA. Section 6BA precludes any imputation of a cost that might have resulted from the operation of the principle in Curran (1974) 131 C.L.R. 409 unless the bonus shares are assessable income and the taxpayer is not a company (s. 6BA(2) and (4)). There cannot in any case be a deductible loss under s. 26AAA.

12.155 The taxpayer may dispose of some of the original shares or the bonus shares in response to a share exchange takeover bid. The share
exchange is a sale for purposes of s. 26AAA: it is made so by s. 26AAA(1) (f). The value of the shares received in exchange will be the proceeds of the sale. The cost of the original shares and of the bonus shares will be affected by the operation of s. 6BA. Section 26AAA cannot give rise to a loss.

12.156 Shares acquired in exchange will be deemed to have been purchased (s. 26AAA(1)(f)). They will have a cost equal to their value at the time they were taken in exchange. Section 26AAA cannot give rise to a loss.

The operation of ordinary usage principles in relation to business income

12.157 The original shares may be held as trading stock of a continuing business of dealing, or as revenue assets, though not trading stock, of a continuing business. The shares may be sold after a bonus or rights issue attendant upon the shares has been made. In the circumstances the Commissioner may have power to adjust the cost of the shares. Where there has been a bonus issue and the original shares are trading stock, the Commissioner's power will rest on s. 6BA and may also rest on s. 52A. The adjustment in the case of s. 6BA will be made under s. 6BA(3)(a). An adjustment in the case of s. 52A would be made under s. 52A(1) and (2). Where the adjustment is under s. 52A there is simply an adjustment to the cost of the original shares so as to deny some of the cost, and no transfer of the cost denied to the bonus shares. Presumably it would not be open to the Commissioner to rely on s. 52A and refuse the operation of the more specific provisions of s. 6BA which require a transfer of cost.

12.158 Where there has been a bonus issue and the original shares are revenue assets but not trading stock the Commissioner's power will rest on s. 6BA(3)(b). There will be no power to adjust cost under s. 52A.

12.159 The Commissioner has no power under s. 6BA to transfer any part of the cost of the original shares to rights that have been issued attendant upon those original shares. Nor has he any power under s. 52A to deny any part of the cost of the original shares save where the original shares are trading stock. An adjustment under s. 52A does not involve any transfer of cost from the original shares to the rights issued attendant upon those shares.

12.160 If rights issued attendant upon the original shares are sold they will have a cost determined by the principle in Curran (1974) 131 C.L.R. 409. The allowance of such a cost gives a rogue operation to the law, save where the Commissioner has disallowed under s. 52A some part of the cost of the original shares, the Commissioner having power to disallow because
the original shares are trading stock. Section 25A(10)(d) has no operation to exclude the principle in Curran. Section 25A, it is assumed on the basis of the judgments of Gibbs C.J. and Mason J. in Whitfords Beach (1982) 150 C.L.R. 355, has no operation in an ordinary usage business situation.

12.161 If the rights are exercised and the shares subscribed for are sold, the cost of the shares will include the value of the rights at the time of issue and the subscription amount: Executor Trustee & Agency Co. of S.A. Ltd (Bristowe's case) (1962) 36 A.L.J.R. 271. Section 6BA will have no application to deny the Curran cost.

12.162 Where the bonus shares are sold they will have as a cost the amount of any cost of the original shares transferred in accordance with s. 6BA(3). But they will not have a Curran cost unless the bonus shares are assessable income and the taxpayer is not a company (s. 6BA(2) and (4)).

12.163 If the original shares or the bonus shares are disposed of in response to a share exchange takeover bid the value of the shares received in exchange will be proceeds that will be assessable income where the shares are trading stock, or will enter the determination of a profit that is income where they are revenue assets of a continuing business. In this instance the question whether the share exchange is a sale is not raised. The exchange is a realisation which is the occasion of a derivation of proceeds or of an element of profit in the proceeds.

12.164 When the shares taken in exchange are sold they will have a cost equal to their value at the time of the share exchange—the amount brought to account in determining the assessable income, or the profit that is income on the disposal of the original or bonus shares.

Where section 26AAC applies

12.165 Tax accounting in relation to transactions in shares and rights to shares in circumstances which do not involve bonus issues or rights issues presents some difficulties. There are further difficulties when a bonus or a rights issue is involved. The difficulties are extreme when the transactions attract the operation of s. 26AAC.

12.166 Section 26AAC is at least primarily concerned with the acquisition of shares or rights to acquire shares under a scheme for the acquisition of shares by employees, though subs. (1) would appear to make the section applicable in circumstances where the taxpayer is not an employee if the acquisition of shares or rights was “in respect of, or for or in relation directly or indirectly to . . . services rendered by the taxpayer or a relative of the taxpayer”. Some comment on the operation of s. 26AAC is made in [2.25]ff., [2.35], [4.20], [4.82]–[4.83], [4.85], [4.134]–[4.137] above. The
present concern is with the problems of tax accounting to which the section may give rise.

12.167 It will be assumed in what follows that a taxpayer who is a director of a company takes up an offer of options over the company's shares, the offer having been made to him because he is a director, and pays a nominal amount for the options. The options are exercisable between specified dates. The exercise price is the market value of the shares at the time of the offer of the options. The taxpayer exercises the options, and thereafter sells the shares. There has been at all relevant times a steady and continuing increase in the market value of the company's shares.

12.168 If s. 26AAC does not apply, the tax accounting will follow general principles, supplemented by s. 26(e). There will be a derivation of income at the time the taxpayer takes up the offer of options (Abbott v. Philbin [1961] A.C. 352 and Donaldson (1974) 74 A.T.C. 4192). The amount of income will be the “value to the taxpayer” of the options less the amount paid by him in accepting the offer of options. The effect, in the determination of this value, of the fact that the options are not immediately exercisable, and the bearing of any inside information about the company's affairs that the taxpayer may have, are discussed in [2.15]ff. above. The possible operation of s. 25A(1) or of s. 26AAA if the taxpayer subsequently exercises the options and thereafter sells the shares thus acquired, is considered in [2.18]ff. above.

12.169 If s. 26AAC is applicable, the offer and acceptance of the options will not give rise to a derivation of income. General principles of derivation of income by ordinary usage are, it is assumed, excluded to this extent, though subs. (10) might have been more appropriately drafted. The assumption is made in the anticipation of legislative action to correct the consequence, explained in [1.39], [2.223] and [2.369] above, of the words added to s. 25(1) in 1984. Those words direct an inescapable inference that s. 26AAC cannot be treated as a code displacing ordinary usage principles. There may be a derivation of income by the taxpayer if he disposes of his options to a person who is not his associate. “Associate” is defined in s. 26AAC(14). There will be a derivation of income in the “amount received by the taxpayer as consideration for the right less the amount paid or payable by him as consideration for the right” (s. 26AAC(8)). It follows that a gift of the options to a person who is not an associate will preclude a derivation of income. There will be no derivation of income under s. 25A (1) first limb on the gift of the options even if it can be said that the options were acquired with the relevant purpose, since there is no sale, though there is the prospect that the donee will acquire with a deemed purpose of profit-making by sale under s. 25A(5). There will be no derivation of
income under the second limb of s. 25A(1) if it be assumed that the simple acquisition and disposition of property is not a scheme. In any case the gift will, it seems, abort the scheme. There will be no derivation of income under s. 26AAA, though the gift is made within 12 months, because there has been no purchase. The inference to be drawn from paras (d) and (e) of s. 26AAA(1) is that the acquisition of rights that arise at the moment of acquisition is not a purchase of those rights.

12.170 The sale of the options to a person who is not an associate could involve a derivation of income under s. 25A(1), as well as under s. 26AAC. Subsection (11) seeks to prevent double taxation by providing that the amount that would be income as a result of the operation of s. 26AAC(8) shall be reduced by so much of that amount as does not exceed the amount that would be included in the income of the taxpayer by virtue of another section of the Act. It might be asked whether subs. (11) in this aspect of its operation is necessary. An amount derived that is income on two grounds could not be income twice over.

12.171 A disposition of the options by the taxpayer to an associate is not an occasion of the operation of s. 26AAC(8). There may, however, be an operation of s. 26AAC(7) if the associate, or another associate who has acquired from an associate, disposes of the options to a person who is neither an associate nor the taxpayer himself. In these circumstances the income of the taxpayer includes the amount, if any, received by the associate who disposes to a person who is not an associate, as consideration for the options, less the amount, if any, paid or payable by the taxpayer as consideration for the options. Each of the dispositions that will have occurred could have generated a derivation of income either under s. 25A(1) or, in the cases of all dispositions other than the first, under s. 26AAA. And if the associate is a dealer in options and shares there could have been a derivation by him in the operation of the trading stock provisions. Subsection (11) has a necessary operation to prevent what might be seen as double taxation in these circumstances. The amount of income derived by the taxpayer is reduced by the amount or amounts of income derived by the taxpayer or an associate, in the first disposition to an associate and in subsequent dispositions by associates or by the taxpayer. In one instance the operation of subs. (11) may defeat the intention of s. 26AAC. A company that is a share trader and an associate of the taxpayer might buy the options and sell them to the taxpayer or another associate at a time immediately before the sale by the taxpayer, or an associate, to a person who is not an associate. The associated company share dealer, if the purchase and sale by it are at market value, will derive little, if any, profit, but it will derive “assessable income” in the amount of the proceeds of
sale. This assessable income will in general generate a tax liability for the associated company, only to the extent that it exceeds the price paid by the company for the options. Yet subs. (11) will allow an abatement of the amount that would otherwise be income derived by the taxpayer under subs. (7) to the full extent of the amount that was included in the assessable income of the company.

12.172 If the taxpayer exercise the options, there will be a derivation of income by him under s. 26AAC(5), unless the taxpayer's right to dispose of the shares he has acquired in the exercise of the options is restricted, or the taxpayer is liable to be divested of his ownership of the shares so acquired. The amount of income derived will be the value of the shares at the time they were acquired by the taxpayer, less the amount paid by him on the exercise of the options and the amount paid by him when he took up the offer of the options. The value of shares will be the market value and not the value to the taxpayer. If value to the taxpayer were applicable, inside knowledge of the affairs of the company might have had a bearing on value.

12.173 When the taxpayer disposes of the shares acquired in exercise of the options there may be a derivation of income. Derivation will not depend on any provision of s. 26AAC, though the amount of income treated as derived may be reduced by the operation of s. 26AAC(12). That subsection requires that the amount derived by the taxpayer on the disposition of the shares be reduced by so much of that amount as does not exceed the amount included in his income under s. 26AAC(5). The reduction is intended to prevent double taxation. It is at least arguable that double taxation is in any case prevented by a general principle which would assert that where an item is an income receipt, or is a receipt that will enter the calculation of a profit that is income, it must, for purposes of determining income derived on any further transaction involving the realisation of that item, be treated as having a cost equivalent to the amount at which it was brought to account as income or at which it was brought to account in calculating a profit that is income. It would follow that for purposes of calculating a s. 25A(1) profit or a s. 26AAA profit in relation to the acquisition and realisation of the shares, the shares must be given a cost in the amount of their value for purposes of the earlier operation of s. 26AAC(5). The function of subs. (12) of s. 26AAC is thus obscure. Clearly it would be an absurd outcome if the taxpayer could have the value of the shares as a cost for purposes of s. 25A(1) or s. 26AAA and at the same time enjoy the reduction provided for in subs. (12).

12.174 The options might have been disposed of by the taxpayer to an associate who in turn exercised the options. Section 26AAC(6) will make
the acquisition of shares by the associate an acquisition by the taxpayer, and there will be a derivation of income by the taxpayer under s. 26AAC (5). The calculation of the amount of this income would involve the value of the shares, less the amount paid by the taxpayer in accepting the offer of the options and the amount paid by the associate in exercising the options. The associate may subsequently dispose of the shares he acquired in the exercise of the options. In which case s. 26AAC(12) is directed to avoiding an assumed double taxation arising from the inclusion of what is seen as the same profit in the income of the taxpayer and of the associate. The income derived by the associate is reduced by so much of the amount of that income as does not exceed the amount included in the income of the taxpayer. Where the associate has acquired the options from the taxpayer, he will presumably have paid an amount that reflects the increase in value of the options between the time of their acquisition by the taxpayer and the time of their acquisition from the taxpayer by the associate. The income derived by the taxpayer, which will reflect the increase in the value of the options from the time of his acquisition to the time of exercise, will thus cover a profit which in part would not come to be included in the profit derived by the associate. To reduce the associate's income by the whole of the amount that is income of the taxpayer is, in effect, to allow some profit to go untaxed to anyone.

12.175 Options may have been disposed of by the taxpayer to an associate who may in turn have disposed of the options to another associate who exercises the options. Indeed there might have been a reacquisition of the options by the taxpayer from the associate and a disposition of them to another associate who then exercises the options. The operation of s. 26AAC(5) on this exercise could involve the taxing of a profit which has in effect been already taxed in part to an associate or to the taxpayer. Subsection (12) does not appear to deal with such a double tax situation. It is confined to a situation of first disposition after the acquisition of the shares.

12.176 The shares acquired by the taxpayer in the exercise of the options may be subject to restrictions on rights to dispose or may be liable to be divested. In this event the operation of s. 26AAC(5) is deferred until one of two events occurs: either the shares cease to be subject to the restriction or the liability to be divested, or the shares are disposed of by the taxpayer. For purposes of s. 26AAC(5), the shares are deemed to have been acquired by the taxpayer at the time when the shares ceased to be subject to the restriction or the liability to be divested, or the time immediately before the taxpayer disposed of the shares, whichever event first occurs. Where the acquisition is deemed to be at the moment immediately before the shares
are disposed of, the shares will be valued at that time for purposes of the operation of s. 26AAC(5). They will be given a value that reflects the restrictions on disposition or the liability to be divested. A gift to an associate will presumably be a disposition for purposes of s. 26AAC(15), and such a gift may bring about some defeat of the policy of s. 26AAC.

12.177 The operation of s. 26AAC(12) in circumstances where the operation of s. 26AAC(5) has resulted from a disposition of the shares is perplexing. The gift of the shares referred to in the last paragraph above may generate a profit that is income under subss (2) and (4) of s. 26AAA, the gift being treated as a sale at market value. Paragraph (b) of subs. (12) refers to the “first disposition” of the shares after an acquisition that will bring about a derivation of income under s. 26AAC(5). The gift by virtue of s. 26AAC(15) brings about an acquisition, for purposes of s. 26AAC(5), that is deemed to occur immediately before the disposition constituted by the gift. An analysis is thus possible which would treat s. 26AAC(12) as applicable, so that the s. 26AAA profit will be reduced by the amount that is income under s. 26AAC(5). The profit and this amount will be the same. If s. 26AAC(12) is not applicable, the taxpayer must assert a principle that an amount which is income on more than one basis is not several amounts of income. The fact that there are two amounts derived separated only by the deeming that one is immediately before the other, should not affect the operation of the principle.

12.178 Shares may, in fact, have been acquired by the taxpayer, but that acquisition may not yet have generated the operation of s. 26AAC(5) because the shares are subject to restrictions on disposition, or the taxpayer is liable to be divested of his ownership of them. There is as yet no acquisition for purposes of s. 26AAC(5). A bonus issue of shares in respect of those shares is made, the bonus issue shares being subject to the same restrictions or liability. There is an initial question whether the bonus shares are shares acquired “under a scheme for the acquisition of shares by employees” as those words are defined in s. 26AAC(1). It is at least arguable that they are acquired “in respect of or for or in relation directly or indirectly to . . . services rendered” by the taxpayer. Indeed it is arguable that they are acquired under a scheme even if the original shares are not subject to restrictions, or there is no liability on the taxpayer to be divested, so that s. 26AAC(5) has already operated in respect of them, and there are no restrictions or liability applicable to the bonus shares. At least in those circumstances there will be some apparent conflict between s. 26AAC(5) and s. 44(2). The apparent conflict may be resolved by drawing attention to the fact that *Gibb* (1966) 118 C.L.R. 628, overruling *W. E. Fuller Pty Ltd* (1959) 101 C.L.R. 403, held that s. 44(2) does no more than avoid an
operation of s. 44 that would give an income quality to the amount notionally distributed in a bonus issue. It does not preclude any general principle or other specific provision giving an income character to some aspect of a bonus share issue.

12.179 If the bonus shares are to be regarded as acquired under a scheme, the operation of s. 6BA is excluded (s. 6BA(1)). The question then raised is whether the operation of s. 26AAC(5) in relation to the bonus shares will allow as a cost the amount notionally paid up on the shares that are the subject of the bonus issue. The view taken in this Volume would reject as incorrect the law in the judgments of Barwick C.J. and Gibbs J. in Curran (1974) 131 C.L.R. 409, and would ask for a reconsideration of that decision by the High Court. While Curran remains an authority, it is arguable that the amount paid up in the bonus issue is to be treated as an “amount paid” by the taxpayer for the bonus shares, as those words are used in s. 26AAC(5). There may not be “expenditure”, but the definition of amount paid in s. 26AAC(17) is not an exclusive definition. Some support might be gained from the express provision in s. 6BA(8) which, when s. 6BA operates, requires that the amount paid up on bonus shares should not be treated “as being an amount paid . . . in respect of the bonus shares”. If the amount paid up is an amount paid as consideration for the bonus shares, a bonus issue on shares that are subject to a scheme for the acquisition of shares within s. 26AAC becomes a means of tax planning, offering like tax advantage as those held to be available generally in Curran, and now denied by s. 6BA. The planning would ensure that the bonus shares and the original shares are affected by a restriction or liability that will defer the operation of s. 26AAC(5).

12.180 The amount paid up on the bonus shares will “not be treated as being an amount paid or payable by the taxpayer in respect of the bonus shares or as in any way constituting any part of the cost to the taxpayer of the bonus shares” if a profit on realisation of the bonus shares falls to be taxed under s. 26AAA (s. 6BA(2)). Section 6BA(2) would equally apply in determining a s. 25A(1) profit. Section 25A(4) will make the operation of s. 25A(1) possible where bonus shares are involved: it overcomes Miranda (1976) 76 A.T.C. 4180. The profit under s. 26AAA may exceed the amount that is income under s. 26AAC(5). It is true that s. 26AAC(12) will reduce the amount that is income under s. 26AAA by the amount that is income under s. 26AAC(5), but the advantage of having the amount paid up on the bonus shares treated as a cost is defeated. Where s. 26AAC(5) operates at the moment before a disposition of shares that are subject to restriction or liability to be divested, any profit that is income under s. 26AAA arising on the disposition can be reduced by s. 26AAC(12) only to the extent of the
amount of the s. 26AAC(5) income. There is a qualification that should be made to these statements. When the s. 26AAA profit is calculated, s. 6BA (3) will allow a deduction of some part of the cost of the original shares and for this reason the s. 26AAA profit in respect of the bonus shares might be less than the s. 26AAC(5) profit. But a s. 26AAA profit in respect of the original shares will be increased by the operation of s. 6BA(3), since the cost of those shares will be reduced by the amount of the cost that is now attributed to the bonus shares. The s. 26AAA profit in respect of the original shares will thus exceed the s. 26AAA(5) profit, which would suggest that a disposition that will bring on the operation of s. 26AAA and s. 26AAC(5) should be made only of the bonus shares. There is advantage in delaying the disposition of the original shares so that more than one year has elapsed since acquisition. Acquisition for this purpose will be the time of exercise of the options. In the case of the bonus shares the time of acquisition is also the time of the exercise of the options. This is the effect of s. 26AAA(7). That subsection might also settle a question whether there is a purchase of bonus shares for purposes of s. 26AAA when bonus shares are issued. The discussion above has proceeded on the assumption that there is. Section 26AAA(1)(d) operates to deem a purchase. In which case, s. 26AAA(7) will merely shift the time of purchase to the time when the taxpayer exercised the options and acquired the shares. Section 26AAA(7) may do more. It may supply a deemed purchase as well as fixing the time of purchase. There is a question of the meaning of the words “shall be deemed, for purposes of this section, to have purchased the bonus shares at the time when he purchased the shares in respect of which the dividend was payable”.

### Accounting for Debts

12.181 Attention was given in [6.310]ff. above to the notion of a revenue asset as it applies to a debt. A profit or loss on realisation of a debt that is a revenue asset may be income by ordinary usage or deductible under s. 51 (1). A profit or loss on the realisation of a debt receivable that would not be described as a revenue asset may none the less be income or deductible where tax accounting has required that it be brought to account in determining the profit that is income or the loss that is deductible in a transaction that is an isolated venture. A profit or loss on realisation of a debt that is neither a revenue asset nor a debt thus brought to account may be income or deductible under s. 25A(1) and s. 52, and a profit may be income under s. 26AAA.

12.182 Attention was given in [6.322]ff. above to the notion of a liability
on revenue account, and the matter is raised again in regard to accounting for exchange gains and losses in [12.192]-[12.211] below. A profit or loss on the discharge of a liability on revenue account may be income by ordinary usage or deductible under s. 51(1). A profit or loss on the discharge of a debt payable may be income or deductible if the debt payable has been brought to account in determining the profit that is income or the loss that is deductible in a transaction that is an isolated venture.

**Accounting for profit or loss in regard to a debt receivable**

**12.183** Accounting for a profit or loss in regard to a debt receivable must distinguish circumstances to which s. 63 is applicable, a section that may allow the anticipation of a loss deduction, and circumstances where there is a derivation of a profit that is income, or a loss that is deductible under s. 51(1) or s. 52. The circumstances in which s. 63 is applicable are considered in [10.50]ff. above. The accounting contemplated by s. 63(3) involves the prospect of an adjustment if, in a year subsequent to the write-off, there is an amount recovered in respect of the debt that wholly or partly recoups the loss that was the subject of the write-off. The realisation of the debt may thus have tax consequences when there would otherwise have been no tax consequences because there has been a cessation of the business of which the debt was a revenue asset and that cessation preceded the realisation. Save where the debt was trading stock, the realisation of a debt after cessation will not, it seems, generate a profit that is income or a deductible loss. *A.G.C. (Advances) Ltd* (1975) 132 C.L.R. 175, though grudgingly, recognises a principle that the realisation of a debt that was a revenue asset of a business, the realisation being after the cessation of the business, cannot give rise to a loss deductible under s. 51(1). It must follow that the realisation cannot give rise to a profit that is income. The special situation of trading stock is considered in [12.103] above and [14.64]ff. below.

**12.184** There can be no profit that is income, or loss that is deductible under s. 51(1), until the realisation of the debt. Realisation of the debt will occur when the debt is disposed of, when it is released, when there is a receipt by the creditor that will discharge the debt or when the debt becomes commercially irrecoverable. Accounting for the gain or loss requires a balancing of the cost of the debt, normally its amount, and any amount received on the disposition of the debt, the release of the debt or its discharge. Where an amount receivable as a result of realisation is not yet the subject of an actual receipt of the whole amount, issues as to the
manner of accounting for a profit or loss considered in [12.8]ff. above are raised. Where actual receipts have come to exceed the cost of a revenue asset, there will be at least a partial emergence of a profit that will be regarded as derived, and later receipts will involve a further emergence. Where actual receipts do not exceed cost, a deductible loss should not be recognised unless all of the amount that may be judged commercially recoverable has been recovered. This may be seen as the necessary corollary of a profit emerging approach applied to the derivation of a profit.

Accounting for profit or loss in relation to a debt payable

12.185 The recognition of a profit that is income or a deductible loss arising on the discharge of a liability on revenue account, has been principally in the field of exchange gains and losses. The recognition of a gain in *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347, provoked some consideration of a need to recognise gains in other circumstances, and to explain the failure to recognise a gain in the House of Lords decision in *British Mexican Petroleum Co. Ltd v. I.R.C* (1932) 16 T.C. 570, where a taxpayer obtained release from a liability on revenue account by payment of an amount less than the amount of the liability. Reference was made in [6.328] above to the suggestion by Mason J. in *International Nickel* that *British Mexican* is to be explained on the ground that the discharge of the liability was not done in the ordinary course of the taxpayer's business. This would be to acknowledge a principle in regard to gain or loss in the discharge of liabilities parallel with a principle that would seem to be established in regard to gain or loss in the realisation of revenue assets. The adoption of the principle in *Sharkey v Wernher* [1956] A.C. 58 in respect to a revenue asset disposed of otherwise than in the ordinary course of business would require the adoption of a like principle in respect to a liability: the liability would be deemed to have been discharged for its value and any resulting gain or loss treated as income or deductible. The amount paid in securing an actual discharge would be evidence of value.

12.186 The striking of a profit or loss on the discharge of a liability on revenue account will require a balancing of the amount of the liability and any amount outlaid to discharge the liability. Where the amount actually outlaid, which may include penalty interest, is more than the amount of the liability, there will be a deductible loss. There will be a gain that is income where the amount outlaid to discharge the liability is less than the amount of the liability: *Mutual Acceptance Ltd* (1984) 84 A.T.C. 4831. If the
amount of the liability ceases to be payable as a matter of law or commercial probability, there will be a profit that is income from the discharge of the liability.

**Accounting where an item other than cash is taken in satisfaction or given in discharge**

12.187 Some consideration was given in [6.319] and [6.322] above to the meaning of realisation of a debt that may give rise to a profit that is income or a deductible loss, and to the meaning of discharge of a liability on revenue account that may give rise to profit that is income or a deductible loss. What is received in a realisation or what is given in discharge may be some item other than cash. In particular, it may be another receivable or another liability. The receivable or the liability must be valued in determining the proceeds of realisation or the cost of discharge.

12.188 A taxpayer entitled to be paid by a company for goods supplied or services rendered may accept a debenture issued by the company. There will be an immediate question whether he has taken the debenture by way of security or by way of satisfaction of the debt he is owed. In the first case there is no realisation, though there may be a realisation if he exercises his power of sale of the security. If there is no realisation the debt subsists. It may be the subject of a write-off under s. 63 and, on subsequent realisation, there will be a loss deduction or derivation of income. The determination of profit or loss on the subsequent realisation will reflect the amount allowed as a deduction on the s. 63 write-off. If the debenture is taken in satisfaction, there will be a realisation, and a moment for striking a profit that is income or a loss that is deductible. For this purpose the debenture must be valued. The debenture does not necessarily succeed to the character of revenue asset that attached to the original debt. The creditor may have been content to make an investment by lending to the debtor the amount he was owed. The character of the debenture as a revenue asset will then depend on other principles. Thus, the debenture may be an addition to the taxpayer's trading stock, or be a revenue asset of a business of the kind Gibbs J. found to exist in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106.

12.189 But the possibility that the debenture takes on the character of the original debt should not be excluded. There is room for a principle that a taxpayer who takes a debenture in satisfaction of a debt in circumstances where no other way of obtaining payment is commercially open to him, acquires an asset that has the character as a revenue asset that attached to the original debt. Receiving payment of a business debt is an aspect of
carrying on a business. The acquisition of the debenture is thus an acquisition in the course of carrying on the business, and should be treated as a revenue asset. The fact that the debenture is evidence of a debt and that the revenue asset realised was a debt, is not significant. A block of land taken by a taxpayer in satisfaction of a debt that is a revenue asset may equally succeed to the character of the debt, if taking the land is commercially necessary to obtain payment of the debt.

12.190 The decision of Hunt J. in Commercial Banking Company of Sydney Ltd (1983) 83 A.T.C. 4208 is in some conflict with views expressed in this Volume. Some debts owed to the bank as interest presently payable by customers had not been brought to account in earlier years as assessable income of the bank. The interest had become presently receivable before the New Zealand decision in National Bank of N.Z. v. C.I.R. (1977) 77 A.T.C. 6001 at 6034, and at a time when it was assumed that at least that part of an interest receivable whose recovery was doubtful did not have to be brought to account when it became receivable. The Commissioner did not attempt an amendment of earlier assessments so as to bring in as income the interest in question. The taxpayer purported to write-off the debts for interest under s. 63. Hunt J. was not prepared to allow a deduction on this ground, though on this point he was overruled by the Federal Court (sub nom. National Commercial Banking Corp. of Aust. Ltd (1983) 83 A.T.C. 4715). He did, however allow a deduction under s. 51(1). Some consideration should have been given to the question whether the debts had been realised. In failing to consider this issue, the judgment of Hunt J. perpetuates the idea, now given some statutory support in s. 63A of the Assessment Act, that the event which will generate a deduction under s. 51(1) for a loss in respect of a debt is the writing-off of the debt. The matter is discussed in [6.318] above. The allowing of a deduction, notwithstanding that the debts for interest had not been brought to account as assessable income, can be justified on reasoning of a kind adopted by Kitto J. in Country Magazine Pty Ltd (1968) 117 C.L.R. 162. On a true view of the law the debts were derived as assessable income, and were thus revenue assets. The fact that they had not been the subject of an assessment did not affect the matter.

12.191 Another aspect of Commercial Banking Company of Sydney Ltd calls for comment. Hunt J. considered it important that the debts for interest had been added to the principal sum, so that they now themselves bore interest. Only in these circumstances did he think they could attract a s. 51(1) loss deduction. In this aspect, his judgment is in conflict with the view taken in this Volume, and it is suggested, with the law underlying the exchange gains and losses cases. If a debt for goods supplied or for
services rendered is a revenue asset immediately it arises, a debt for interest or rent, as debts for allowing the use of money or land, are revenue assets immediately they arise. It is true that establishing a cost for a receivable depends on an analysis that is not easily expressed: an attempt is made in [6.311], [6.325]-[6.326]. The cost of a receivable is the accommodation granted. But to insist that there must have been a further event in relation to the receivable—sometimes referred to as a “capitalisation”—before it may be regarded as a receivable that has a cost, seems at odds with established authority, in particular the exchange gains and losses cases. And it raises the question—suggested perhaps by the use of the word “capitalised” in the common description of the event—whether the receivable may not have already been the subject of payment followed by a new transaction by which the amount of the payment has been lent to the debtor. The debt on this lending would not necessarily be a revenue asset.

**Accounting for Exchange Gains or Losses**

12.192 The tax law as to when an exchange gain or loss in relation to a debt is income or a deductible outgoing is a particular expression of general principles in relation to gains and losses in respect of debts. It is an exchange gain and loss case, *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510 that has given us what law we may have on the character of a liability as a liability on revenue account, where a debt for money borrowed is involved. The law has been discussed in [6.328]-[6.330] above.

12.193 To describe a gain or loss as an exchange gain or loss is no more than to give a reason why a gain or loss in relation to a debt has occurred. The possibility of treating an exchange loss on the discharge of a liability as an additional interest expense is raised by an observation in the judgment of Rogers J. in *Hunter Douglas Ltd* (1982) 82 A.T.C. 4550 at 4559. Such a treatment would not be consistent with the reasoning in *AVCO Financial Services* where the focus is on the revenue character of the liability. An approach in terms of an additional payment of interest would need to focus on the character of the borrowing as a borrowing of money used to produce income, which is a different character. The matter is the subject of some observations in [6.329] above. An exchange gain could hardly be treated as some kind of reverse interest, and coherence in the treatment of exchange gains and losses is abandoned if a loss is treated as additional interest.

12.194 An exchange gain or loss will most often arise in the receipt of
payment of a debt, or in the making of payment of a debt. It may, however, arise in other ways. Thus a taxpayer may be owed a debt in a foreign currency and that debt is a revenue asset. If he sells the debt for an amount in the same currency he may experience a loss, not only because the amount he receives reflects some doubt about the financial responsibility of his debtor, but also because a change in exchange rate has given rise to the consequence that what he receives in the foreign currency has a value in Australian currency less than its value at the time the debt arose.

12.195 In some sense of “bad”, an exchange loss in relation to a receivable may be seen as a bad debt loss. The taxpayer receives less in Australian currency in payment of his receivable than the amount expressed in Australian currency at which it was brought to account as income, or the amount of the loan expressed in Australian currency at the time of lending where it is a debt on a loan. The reason he receives less is that the exchange rate has moved unfavourably, but one would think that there is no reason to distinguish his situation from that of a taxpayer who receives less because his debtor is not able to pay him in full. Reasoning of this kind might suggest that s. 63 should be available to a taxpayer so that he might have a deduction in anticipation of an exchange loss that is impending. It would be assumed, however, that s. 63 will be interpreted so that the notion of “bad debt” is confined to circumstances where the debtor is unable to pay the full amount.

12.196 The common situations in which an exchange gain that is income or an exchange loss that is deductible may arise are:

(1) a taxpayer buys goods or services and agrees to pay for them in a foreign currency;
(2) a taxpayer sells goods or services and is entitled to receive payment in a foreign currency;
(3) a taxpayer borrows money in a foreign currency repayable in that currency; and
(4) a taxpayer lends money in a foreign currency and is entitled to repayment in that currency.

An income gain, or a loss that is deductible, will generally arise when the liability is on revenue account, and it has been discharged by payment, or the right to receive payment is on revenue account and the taxpayer has received payment. It is assumed that what is a payment and what is a receipt of payment for these purposes is determined by principles examined in [11.122]–[11.149] and [11.174]–[11.187] above, which determine what is a receipt and what is an outgoing by a taxpayer on a cash basis in relation to the item. Notions of constructive receipt and constructive payment will have their applications.
12.197 There may be a profit or loss emerging. Where receipts come to exceed the cost of a receivable there will be a profit emerging. Further receipts will give rise to the derivation of further profits. Where receipts are as yet less than the cost there will be a loss emerging only when there is no commercial prospect of further receipts. Should the commercial prospect prove wrong, and there are further receipts, there will be profit emerging which will in effect adjust the amount of the loss.

12.198 The judicial decisions are concentrated in the area of profit or loss on discharge of liabilities arising in respect of goods or services received or the borrowing of money. There are no cases which concern a gain or loss on the receipt of a receivable.

12.199 Three decisions of the High Court emphasise discharge as the occasion when a profit or loss will be struck in relation to a liability. There is a possible distinction between a change in the nature of a liability, and a discharge of a liability that might be immediately replaced by a new liability. The decisions in Texas Co. (Australasia) Ltd (1940) 63 C.L.R. 382, and Armco (Australia) Pty Ltd (1948) 76 C.L.R. 584 might be taken to reject a view that a profit or loss should be struck when a liability changes its character from a liability on revenue account to a liability on capital account, or to a liability that may be described as a private liability. Attention was given in [12.104] above to a view of the law that would treat a change in the character of a revenue asset, as in Sharkey v. Wernher [1956] A.C. 58, as an occasion of realisation of that asset at its market value. It would be an appropriate extension of such law to treat a change in the character of a liability on revenue account as a discharge of that liability at the arm's length amount that would need to be paid to effect the discharge. Murphy (1961) 106 C.L.R. 146, in holding that a revenue asset that is once trading stock cannot change its character so as to avoid the operation of s. 36, may have established a principle applicable to other revenue assets. In Murphy the business in which the assets were trading stock had itself come to an end. An argument that the assets had in effect become private assets, and could not generate an income gain on realisation was rejected. Murphy does not sit with Sharkey v. Wernher. Sharkey v. Wernher would have required a finding of a deemed realisation at the time the business ceased. Murphy preserves the character of the item so as to allow an operation of s. 36 on actual realisation. The case is at odds with A.G.C. (Advances) Ltd (1975) 132 C.L.R. 175 so far as that case supports a view that a debt that was a revenue asset but is disposed of after the business has ceased cannot generate a loss that is deductible. There may yet be room for a submission that in both Murphy and A.G.C. (Advances) the wrong issue was raised. The issue should have been
whether the undoubted change in character that resulted from the cessation of the business was not a deemed realisation. The applicability of *Sharkey v. Wernher* would then have been raised. And the applicability of a similar principle in relation to liabilities might have been left open for decision. But *Sharkey v. Wernher* has been subject to qualification in the United Kingdom in *Mason v. Innes* [1967] 2 W.L.R. 479, and *Texas Co. (Australasia) Pty Ltd* and *Armco (Australia) Pty Ltd* would appear to reject the decision in its possible application to accounting for debts where an exchange gain or loss is involved.

12.200 The third case emphasising discharge as the occasion when a profit or loss will be struck is *Caltex Ltd* (1960) 106 C.L.R. 205. In that case there was an attempted discharge of a debt in a foreign currency using moneys borrowed in the same currency from a related company. The majority of the High Court took a view of the matter that looked to "reality" and "substance", in holding that there had not been a discharge so as to generate a deductible exchange loss. There is a parallel between this conclusion and that reached by Rich J. in *The Permanent Trustee Co (Executors of Estate of F. H. Prior, dec'd)* (1940) 6 A.T.D. 5 discussed in [11.127] above, in relation to the receipt of payment of moneys owing to the taxpayer for interest on a debt.

12.201 It could hardly be denied that in *Caltex* a new liability had taken the place of the liability that it had been sought to discharge, and the case leaves a question whether that new liability has the revenue character of the initial liability, so that it could generate an exchange gain or loss on its discharge. It will be seen that a borrowing specifically to provide funds to discharge a liability on revenue account may itself be regarded as giving rise to a liability on revenue account. The authorities are *Thiess Toyota Pty Ltd* (1978) 78 A.T.C. 4463 and *Cadbury-Fry Pascall (Aust.) Ltd* (1979) 79 A.T.C. 4346. The new liability in *Caltex*, it would be argued, was a liability on revenue account.

12.202 In *Caltex* the attempt to discharge the debt to the parent company in U.S. dollars was made with U.S. dollars. Which may suggest that a discharge that may give rise to an exchange gain or loss must involve the conversion of Australian dollars into the foreign currency in which the debt is owed. The judgments in the case do not suggest any such rule. It follows that an Australian resident taxpayer engaged in branch operations abroad may make an exchange gain or loss on every payment received for goods or services supplied, or on every payment made for goods or services received, if there is a movement in the rate of exchange of Australian currency for the currency in which the branch operations are conducted. The conclusion may be surprising, but it is inescapable. A transaction
under which foreign currency is acquired may have tax consequences which are distinct from the consequences of the discharge of a liability by payment in a foreign currency. A taxpayer may enter into a transaction by which he is entitled to buy foreign currency in the future at a specified price in Australian dollars, his object being to “hedge” against his possible loss on another transaction under which he will be liable to make a payment in the foreign currency. The first transaction may be seen as incidental to the business activity out of which the latter transaction arose. If the value of the foreign currency has increased in relation to the Australian dollar, the taxpayer may make a gain that is income on the surrender of his rights under the contract in the first transaction; or he may make a gain by the exercise of his rights under that contract to obtain the foreign currency, and the application of foreign currency in discharging the liability in the second transaction. There is a realisation of the foreign currency obtained in the first transaction for the amount in Australian currency required to discharge the liability in the second transaction. The gain that is income in the first transaction will be off-set by the loss that is deductible in the second. A like analysis is appropriate in explaining the consequences of a so-called currency “swap” transaction associated with the discharge of a liability on revenue account. By selling an amount of foreign currency for delivery in the future, a taxpayer may “hedge” against a possible loss on a transaction under which he will be entitled to receive on revenue account an amount in the foreign currency in the future. The contract may be seen as incidental to the carrying on of the business out of which the receivable on revenue account arose. A gain or loss that will be income or deductible arising from the contract to sell the foreign currency will be realised when foreign currency is acquired and delivered under the contract of sale, or when the taxpayer receives an amount in Australian currency or pays an amount in Australian currency, to grant a release or to obtain a release from the contract. A currency “straddle” involving a contract to sell in the future, and a matching contract to buy in the future may give rise to a potential loss on one contract and a potential gain on another. A taxpayer who realises his loss on one contract before year end and takes his gain on the other after year end, may achieve a deferral of income. Matching contracts may be used in the same way where they relate to commodities, so that a commodity straddle is established. The arising of losses and gains that are deductible or income, will turn on the contracts being revenue assets of a business carried on by the taxpayer. A contract is unlikely to be regarded as an isolated business venture or a s. 25A(1) second limb transaction. The contract may be a revenue asset of a business if making contracts of these kinds is incidental to the business operations
of the taxpayer. The taxpayer may be “hedging” against a change in the value of foreign currency which he may have contracted to pay, or to receive in the course of his business, though there may be some reason to doubt that he is hedging when his rights to payment and his obligations to pay in the future in the foreign currency match one another. It is not easy to see how the taxpayer could be said to make matching contracts as a business in itself. A profit purpose is lacking in the view of this Volume, as it was lacking in *Investment & Merchant Finance Corp. Ltd*. The taxpayer may be in business of making profits by speculations in the futures market but the making of matching contracts is not an aspect of that business.

12.203 A taxpayer may be subject to a number of liabilities to the same creditor, some of them on revenue account and some not. There may be a question as to which liability has been discharged by a payment. *Texas Co. (Australasia) Pty Ltd* (1940) 63 C.L.R. 382 may support a view that liabilities must be taken to be discharged in the order in which the debtor became subject to them. There does not appear however to be any reason to deny the application of the general law of appropriation, by which the identity of the debt discharged will be determined by the debtor's appropriation, or, in the absence of action by the debtor, then by the appropriation of the creditor.

12.204 *Texas Co. (Australasia) Pty Ltd* (1940) 63 C.L.R. 382, *Armco (Australia) Pty Ltd* (1948) 76 C.L.R. 584 and *Caltex Ltd* (1960) 106 C.L.R. 205 all involved a claim for a loss in the discharge of a liability. Where a loss would be deductible, a gain will be income. *International Nickel Aust. Ltd* (1977) 137 C.L.R. 347 is authority. The integrity of the law clearly requires such a conclusion. The High Court was impressed by the novelty of a notion of a gain from the discharge of a liability. A loss can be rationalised as a further outgoing, but a rationalisation of a gain as a further receipt is simply not open. *International Nickel*, indeed, is a frank admission by the High Court that, in some circumstances, specific profit accounting is applicable, and displaces receipts and outgoings accounting.

12.205 There is, however, an observation by Mason J. in *International Nickel* which maintains some place for receipts and outgoings accounting in relation to the discharge of a liability. He suggested that if a debt for trading stock is both incurred and discharged in the same year of income, the cost of the trading stock will be treated as the amount in Australian currency paid to discharge the debt. At the same time he recognised that a payment in the following year would be dealt with in terms of profit and loss accounting, and that the cost of the trading stock would remain the amount of the debt incurred expressed in Australian currency. The letting in of receipts and outgoings where the debt is discharged in the year in
which it is incurred may be justified by simplicity in administration and compliance. But it is an abandonment of principle. A taxpayer may buy trading stock for $100, the amount of Australian currency at the time the debt in a foreign currency is incurred, and discharge that liability before the end of the year of income for $120 Australian currency. On the approach suggested by Mason J., he will be denied a present deduction for the $20 exchange loss. If one assumes that the trading stock is still on hand at year end, Mason J. would allow a deduction of $120 but treat this as the cost that will be deferred by the operation of s. 28. The effect is that the $20 loss will be deferred until the year in which the trading stock is sold. These consequences may be compared with the consequences if the debt is discharged for $120 in the next following year of income and the goods remain on hand at the end of that year. The discharge will generate a loss deduction in the year of discharge and there will be no deferral to the year of realisation of the stock. The cost of the trading stock will be $100 and this is the cost deferred to the year of realisation by the operation of s. 28.

12.206 A good deal of attention has been given in judicial decision to exchange gains and losses arising from the discharge of a liability on a borrowing. While the issue is in all cases whether the liability is on revenue account, the notion of a borrowing on revenue account is ill-defined. The matter is discussed in [6.329] above. In AVCO Financial Services Ltd (1982) 150 C.L.R. 510, the High Court rejected the suggestion of Gibbs J. in Commercial & General Acceptance Ltd (1977) 137 C.L.R. 373 that a liability on a borrowing will never be on revenue account. A borrowing made specifically to discharge a liability on revenue account will itself be a liability on revenue account. Thiess Toyota Pty Ltd (1978) 78 A.T.C. 4463 and Cadbury-Fry Pascall (Aust.) (1979) 79 A.T.C. 4346 have not been questioned. Presumably it is the objective purpose or function of the borrowing that is relevant, and tracing of the money borrowed into the money paid to discharge the liability on revenue account is unnecessary. AVCO itself would appear to establish that a borrowing whose function is to finance the acquisition of trading stock, is a borrowing on revenue account. It would be assumed that a borrowing to finance the acquisition of other revenue assets, for example the investments in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106 would be treated in the same way as a borrowing to finance the acquisition of trading stock. And a borrowing to finance loans made by a taxpayer whose business is to lend—the actual circumstances of AVCO—will be a borrowing on revenue account. Though some of the language used in Commercial & General Acceptance Ltd and in AVCO may suggest that an actual tracing of the money borrowed into outgoings on trading stock or other revenue assets, or
the lending on revenue account, is necessary, it would appear that an actual movement of funds in this way is no more than an indication of the function of the borrowing. Put in another way, any tracing required is a tracing through purposes—the notion suggested in [6.86]ff. above in relation to a determination that a borrowing has been used in a process of derivation of income.

12.207 A borrowing whose function is to finance the acquisition of assets that are structural assets of a business or to finance the acquisition of pure investments, will not be a borrowing on revenue account (*Commercial & General Acceptance*). There is thus a vital distinction, already emphasised in this Volume on a number of occasions, between the deductibility of interest on a borrowing and the deductibility of an exchange or other loss in relation to that borrowing. Interest will be deductible where the money borrowed has been used in a process of income derivation by being outlaid in the acquisition of structural assets of a business, or in investment whence income is derived.

12.208 The Federal Court in *Hunter Douglas Ltd* (1983) 83 A.T.C. 4562 would appear to have established that a function in borrowing which is to meet regular business outgoings, other than for the acquisition of trading stock or other revenue assets, or to lend on revenue account, will not give the borrowing the character of a liability on revenue account. A function of the borrowing to provide working capital to be used in the running expenses of a business, expenses that will be consumed and will generally be deductible outgoings, will not give the borrowing the character of a liability on revenue account. The justification for a distinction between a borrowing to acquire trading stock and a borrowing to meet expenses that will be consumed in the running of a business is not evident. If the distinction is to be drawn, the principle for which *Thiess Toyota Pty Ltd* (1978) 78 A.T.C. 4463 and *Cadbury-Fry Pascall (Aust.) Ltd* (1979) 79 A.T.C. 4346 appear to stand would need reconsideration. It is true that in both cases the borrowing was to meet the cost of trading stock. There is, however, no suggestion in the cases that the exchange loss would have been differently treated if the borrowing had been made to meet the costs of shipping the trading stock.

12.209 The difficulties of analysis that have resulted from an approach that focuses on the function of the borrowing in determining the character of the borrowing, may suggest that a different approach concerned with the nature of the borrowing itself is appropriate. The different approach assumes that a distinction can be drawn between the function of a borrowing and the nature of the borrowing itself. The “nature of the borrowing” may be seen as involving a broader characterisation, which
may be assisted by an identification of the function of the borrowing but is not determined by it. The characterisation of the borrowing as a revenue liability will require a conclusion that the borrowing was made in carrying on the business of the taxpayer, which will exclude any borrowing where there is no business. The borrowing may be directly in the carrying on of the taxpayer's business operations, as it will be where it is a borrowing by a bank to lend in the course of its business. It may be a borrowing incidental to the carrying on of the taxpayer's business—a short term borrowing to finance the acquisition of trading stock as in *Thiess Toyota* and *Cadbury-Fry Pascall*. Or it may be a borrowing that reflects system and organisation directed to minimising the cost of borrowing. In the last instance, the borrowing will most often be short term. The longer the period of borrowing the less will be the regularity of borrowing and the less will be the system and organisation that it reflects. In this instance, the notion of a borrowing on revenue account will correspond with the particular notion of a revenue asset reflected in the judgment of Gibbs J. in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106. His judgment recognises a business activity of investing where the investing reflects system and organisation directed to maximising the income that may be derived from the investment. The notion of a borrowing on revenue account will recognise a business activity of borrowing where the borrowing reflects system and organisation directed to minimising the costs of borrowing.

12.210 An approach concerned with the nature of the borrowing itself, function being only an indication of that nature, will resolve the apparent conflict between *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510 and *Hunter Douglas* (1983) 83 A.T.C. 4562. *AVCO* will be explained in terms of a direct business activity of a finance company in borrowing money, and not in terms of the function of the borrowing to finance revenue assets—loans to customers—seen as akin to trading stock. In *Hunter Douglas* a function of the borrowing to acquire trading stock would have made no difference to the outcome. Function can do no more than indicate that the borrowing was incidental to the carrying on of business. In *Thiess Toyota Pty Ltd* (1978) 78 A.T.C. 4463 a borrowing resulting from a transaction effected by a commercial letter of credit was incidental to the carrying on of business. The borrowing from the parent company in the circumstances of *Cadbury-Fry Pascall (Aust.) Ltd* (1979) 79 A.T.C. 4346 might be seen as incidental to the carrying on of business, and the decision explained in that way, but only where the borrowing is no more than a convenient way of discharging the liability to the supplier, and is not a continuing provision of funds by a parent to its subsidiary.

12.211 It is generally assumed that the liability of a purchaser of goods or
services to pay for those goods or services is a liability on revenue account
where the liability is deductible as an outgoing by a taxpayer on an
accruals basis of accounting. Where, however, the goods or services have
been provided under an agreement by which a long term has been allowed
for payment, there is room to argue that the character of the liability should
be judged in the same way as that directed by the approach suggested in
the last paragraph to the determination of the character of a borrowing—an
approach that looks to the nature of the borrowing itself. This would be to
revive the Commissioner's argument in *Texas Co. (Australasia) Ltd* (1940)
63 C.L.R. 382 and *Armco (Australia) Pty Ltd* (1948) 76 C.L.R. 584, an
argument that may appear to have been rejected in those cases. It is true
that these two cases can be explained on the basis that a change in the
initial character of a liability does not have any tax consequences. That
however is not a view of the law that should be supported. A principle that
is parallel with the principle in *Sharkey v. Wernher* [1956] A.C. 58
applicable to assets should be recognised so that there is a deemed
discharge of a liability for the amount of its value on the occasion of the
change in character. If an approach in terms of the nature of the liability
itself is to be taken, in relation to borrowings or other liabilities, in
determining whether the liability is on revenue account or capital account,
it will not be possible to preserve all principles that the cases may be
thought to support. Some of those principles are, in any event, strange
bedfellows.

**Accounting for Premiums on the Repayment of Loans, and
Discounts allowed on the Undertaking of Liabilities to Repay Loans**

12.212 Attention has been given in [11.252]–[11.267] above to the
characterisation of premiums on the repayment of loans, and discounts
allowed on the undertaking of liabilities to repay loans. The emphasis was
on the possibilities of treating the premium or discount as income in the
nature of income derived from property by the original lender, or by an
assignee of the lender, and of treating the premium or discount as an
outgoing incurred by the borrower in paying for the use of the money
borrowed. Original issue discount or premium may, it seems, be treated as
income derived from property by the original lender, though the time of
derivation is likely to be regarded as the moment when the debt becomes
repayable, in the case of an accruals basis taxpayer, or the moment of
actual or constructive receipt by a cash basis taxpayer. And the moment of
incurring of an outgoing by the borrower is likely to be regarded as the
moment when the debt becomes repayable, in the case of an accruals basis taxpayer, or the moment of actual or constructive payment in the case of a cash basis taxpayer.

12.213 Where the premium or discount is not treated as a gain derived from property or a deductible outgoing, the possibility that it will give rise to a profit that is income or a loss that is deductible must be considered. Such a possibility depends on the character of the lending as an asset of the lender, and the character of the borrowing as a liability of the borrower. Income derivation will require that the asset be held by the taxpayer as a revenue asset, or that it be an asset that will be realised in the carrying out of an isolated business venture or a transaction within s. 25A(1) or s. 26AAA. The deductibility of a loss will require that the liability be a liability on revenue account. The circumstances in which a debt for money lent will be a revenue asset, and a liability to repay money lent will be a liability on revenue account, have been explored in relation to accounting for debts ([12.181]–[12.191] above) and accounting for exchange gains and losses ([12.192]–[12.211] above). An asset held as a pure investment will not generate a profit that is income on its realisation unless s. 26AAA applies, though it may be the source of a receipt that is income as a gain derived from property. A liability that is not held on revenue account cannot generate a loss that is deductible, but a payment for the use of the money acquired in exchange for the undertaking of a liability may be deductible, even though the liability is not on revenue account, if the money acquired has been used in a process of income generation.

12.214 The vital difference between circumstances when receipts and outgoings accounting is appropriate, and the circumstances where profit or loss accounting is appropriate becomes evident. That vital difference is at the heart of the debate as to the appropriate treatment of the greater amount a taxpayer may receive on the sale or redemption of a bond over the amount that he paid for it. The assumption of s. 23J of the Assessment Act is that the greater amount is income as a gain derived from property. The section is, it seems, intended to have an operation so as to give an exemption, limited to acquisitions at a discount prior to 30 June 1982, in circumstances other than those which could give rise to a profit that is income. Subsections (2) and (3) of s. 23J, the exclusion provisions, extend to all circumstances in which a profit might be income, save an isolated business venture. It would not seem that the purchase and sale of a bond or the purchase and redemption of a bond could be an isolated business venture. The section will thus have no operation, or an operation in only a rare event, if the greater amount is not income as a gain derived from property.
The discussion in [2.285]ff. above would indicate that it may be possible to treat the greater amount as income as a gain derived from property in the circumstances of *Lomax v. Peter Dixon & Co. Ltd* [1943] K.B. 671, where there is a repayment of the moneys lent and the payment is made to the original lender. And it may be possible to treat the greater amount as income derived from property wherever the bond is held by the taxpayer until redemption. The possibility that the greater amount will be income derived from property where it is the surplus on sale of a bond over its purchase price seems indeed remote.

Where a discount or premium is income as a profit derived, or is deductible as a loss on the discharge of a liability, the accounting appropriate will be specific profit or loss accounting, and will follow the general principles explored in [12.8]ff. above. The moment for striking a profit or loss will be an actual or constructive payment. Profit emerging will apply so that profit is derived as receipts come to exceed cost—the money lent, or the cost of the debt for money lent—and loss is incurred as payments come to exceed the loan moneys that were received.

### The Treatment of Discounts on the Negotiation of Bills of Exchange

The possibility that a discount on the negotiation of a bill of exchange will be income as a gain derived from property, or deductible as an outgoing incurred for the use of money, was explored in [11.264]–[11.267] above. The more likely possibility is that the discount is income as a profit or deductible as a loss, though this possibility involves different principles. Those principles were not discussed in *Willingale v. International Commercial Bank Ltd* [1978] A.C. 834 where the taxpayer was a bank and the bill of exchange was held in the ordinary course of carrying on its business. Conceivably a taxpayer may invest in a bill of exchange though the very nature of the security suggests that it will be held in the carrying on of a business. Where it is held as an investment the inference that a s. 25A transaction is involved will be strong, and s. 26AAA may apply. Neither s. 25A nor s. 26AAA will apply where the bill is held to maturity. There is no sale for the purposes of either section, despite, in the case of s. 26AAA, the widened meaning given to that word by s. 26AAA(1)(f).

Deductibility of a loss incurred by a party to the bill in paying it depends on a conclusion that his liability on the bill was on revenue account. The principles by which a liability will be characterised as a liability on revenue account remains confused. The decision of the High
Court in *AVCO Financial Services Ltd* (1982) 150 C.L.R. 510 has not dispelled the confusion. The matter is considered in relation to exchange gains and losses in [12.192]–[12.211] above. Where the liability is that of an indorser of a bill of exchange, it will most often be on revenue account for the same reason that the bill whose endorsement gave rise to the liability was a revenue asset of the indorser. In other circumstances, a study of *AVCO* and *Hunter Douglas Ltd* (1983) 83 A.T.C. 4562 is inescapable.

12.219 The accounting that will be applicable will follow profit and loss accounting in relation to loans. Where a taxpayer has endorsed a bill on its sale to another, and is called on to pay the bill, there will be a loss to the extent that what he pays in discharge of his liability on the bill exceeds what he will recover from other parties to the bill. There will be a question whether the striking of the loss will proceed on the basis of bringing in the amount he is entitled to recover from other parties. If it does, there may be no loss, save where his rights to recover from others do not realise their amount. This question is an aspect of a more general question of accounting for profit or loss considered in [12.12] above. The suggestion there is that there is a loss that emerges only when actual recoveries are less than the amount paid to discharge the liability and further recoveries are commercially unlikely. Further recoveries after the striking of the loss will be items of income.

**Accounting where the Circumstances Reflect Multiple Bases of Income Character, Embracing Several Derivations of Income**

12.220 A single item derived may have an income character because of the operation of more than one of the principles that make up the ordinary usage notion of income, or the operation of one or more of those principles and a specific statutory provision. Thus, a fee charged by a taxpayer practising a profession will have an income character for the reasons that it is a gain from carrying on a business, and a reward for services, or for these reasons and the operation of s. 26(e). Such an item is income in its amount once only. It is not to be regarded as being as many items of income as there are reasons for concluding that it has an income character. So too, a single outgoing may be deductible under s. 51(1) and under some specific provisions, such as s. 53, relating to repairs. It is deductible in its amount once only.

12.221 Circumstances in which there is a single item derived which has multiple bases of income character are, however, to be distinguished from circumstances which reflect multiple bases of income character and
embrace several derivations of income. The more likely illustrations involve the disposition of property or the provision of services by a taxpayer for a consideration that is an annuity, or for a consideration that is an assignment to the taxpayer of rights to future receipts.

Disposition of goods or the provision of services in exchange for an annuity

12.222 In *Just* (1949) 23 A.L.J. 47, discussed in [2.220] above, the taxpayer disposed of land for a consideration that involved the payment to him over a number of years of a percentage of the gross rents of a block of shops owned by the buyer. The receipts by the taxpayer were held to be income as an annuity. There was no suggestion that the land disposed of was held by the taxpayer as trading stock of a business of dealing in land or as a revenue asset of any business carried on by him, or was held in carrying out an isolated business venture or in circumstances that attracted the operation of the equivalent to s. 25A(1), or would now attract the operation of s. 26AAA. The annuity receipts were income as such. There was then only one basis of income character reflected in the transaction. On the analysis explained in [2.220] the taxpayer should have been treated as having purchased the annuity by the outlay of the land. The value of the land at the time of the transaction should have been treated as undeducted purchase price of the annuity and substractions under s. 26AA, now s. 27H, made from each of the annuity receipts.

12.223 A different analysis would however have been appropriate, if the land had been trading stock of a business of dealing in land carried on by the taxpayer, or had been held in such circumstances that a profit on realisation would be income. There would then have been two derivations, each of an income character, reflected in the proceeds of the disposition of the land—a gain in carrying on a business, or carrying out a business venture or transaction in which a profit is income—and annuity receipts. Identifying the two derivations requires a break-up of the circumstances into two elements: a disposition for a consideration being the promise to make the annuity payments, and the receipt of annuity payments under that promise. In this way a realised profit on the disposition of the asset will be brought to tax, and the annuity receipts will be brought to tax with a purchase price, for purposes of s. 27H, of the value of the promise brought to account in the determination of the profit that is income. The accounting thus required reflects the principle that where an item of an income character, or one that must be brought to account in determining a profit that is income, is derived and that item is a cost in a further derivation of income, it must be treated as a cost in the amount at which it was brought
to account. It is true that the law has not adopted a general approach of treating the present value of a series of future receipts as the proceeds of a transaction of sale of property or services by a taxpayer. But the approach has not been rejected and should not be rejected in the context now being considered, where the receipts are income on a basis of characterisation that has no concern with the origin of the obligation to make the payments. The approach would, indeed, be appropriate where the taxpayer is on a cash basis in regard to the disposition of the property. The present value of the annuity must be taken to have been received. The circumstances bring s. 21 into operation: consideration has been given otherwise than in cash. The promise to pay the annuity is a chose in action that is to be distinguished from a simple promise to pay money, which would involve a derivation by a cash basis taxpayer entitled to receive payment, only on actual receipt. The promise to pay should be treated in the same way as the promise to issue shares involved in the issue of options in *Abbott v. Philbin* [1961] A.C. 352 and *Donaldson* (1974) 74 A.T.C. 4192.

12.224 The cost of the annuity will be the amount of its value brought to account in determining the income arising from the sale of the property. That cost will be applied under s. 27H over the period of the annuity, against the annuity receipts. The principle of tax accounting dictates the construction of “purchase price” for purposes of s. 27H.

**Disposition of goods or the provision of services in exchange for a right to future receipts**

12.225 The tax consequences of an assignment of rights to future receipts is the subject of discussion in Chapter 13 below. The view is there taken that an assignment of the right to future receipts, effective by the general law, may shift liability to tax on those receipts from the assignor to the assignee. The emphasis in that statement of view is on the word “right” in the phrase “right to future receipts”. A transfer of an expectancy of future receipts, though effective as far as it can be by the general law—which would require that consideration be furnished by the transferee—cannot shift liability in this way, unless the property on which the expectancy is attendant is itself assigned. Thus, an effective assignment of the right to future receipts in a *Shepherd* (1965) 113 C.L.R. 385, situation—involving future receipts under a licence given to use patent rights—will pass tax liability on those receipts from assignor to assignee. An assignment of an expectancy of future receipts in a *Norman* (1963) 109 C.L.R. 9 situation—interest receipts that will fail to arise if the debt is repaid by the borrower—will be effective when made for value, but it will not pass tax liability on
those receipts unless the assignment accompanies an assignment of the
debt on which the future receipts are expectant.

12.226 An employer, contractually bound to reward his employee in this
way for services the latter has performed, may transfer his claim to future
receipts of interest under debentures. If his claim is a right—as in the
circumstances of *Shepherd*—there will be a derivation by the employee of
income in the amount of the value of the right at the time of the transfer.
There will be further derivations of income by the employee as actual
receipts of interest arise. Those receipts will not be income of the
employer. The receipts are income of the employee as gains derived from
the right to future receipts. The receipts will be income, notwithstanding
that the debt on which the interest receipts are attendant has not itself been
transferred. In these circumstances, the scope of the principle of tax
accounting referred to in [12.223] above is tested. The principle has so far
been identified as a principle that the item that is income must be treated as
being a cost equal to the amount of that income in determining any profit
that is income on the realisation of the item. In the case of the annuity
considered in [12.222]ff. above, the annuity receipts were regarded as
proceeds of realisation of the annuity. In so regarding them, there may be a
widening of the principle of tax accounting so as to make it applicable in
the circumstances of receipts under a right to future receipts. If the
principle does so apply, receipts by the assignee who has derived income in
the assignment to him of the right to the receipts will be income only as a
profit emerges, presumably when the receipts come to exceed the deemed
cost of the right to those receipts. In this context, the principle of tax
accounting merges into another principle which has been argued for in a
number of places in this Volume: where there are receipts that are income
derived from property and the property is consumed in part in generating
each receipt, the value of the property, as it is consumed, should be
subtracted from the receipts in determining the amount of each of them
that is income.

12.227 If the employer's claim is not a right to future receipts but an
expectancy of future receipts, there will be a derivation of income by the
employer in the amount of each receipt as it arises. Each receipt will arise
as it becomes receivable and subject to a trust in the hands of the employer
in favour of the employee. Each receipt is income of the employee as a
reward for services: the item of receipts is the equity in the receivable
which vests in the employee. The receivable is not at any time income of
the trust of which the employer is trustee. It is corpus of that trust ([13.9]
below). There is a derivation by the employee in the receipt of the equity in
that corpus. Derivation is confirmed by s. 21, which provides that where
consideration is given otherwise than in cash, the money value of the consideration shall be deemed to have been given.

12.228 The employee's equity in the receivable will have a cost equal to its value. That cost will be significant if the employee disposes of his equity in circumstances that may generate a profit that is income, or a loss that is deductible. But the cost will not otherwise be significant. An actual receipt by the employer trustee for the employee will not be income of the trust. There is only a receipt in realisation of an item that has been received as corpus of the trust. There is no gain derived from property of the trust. And there can be no derivation of income by the employee beneficiary of that trust. These propositions are stated summarily: they are more closely explained in the chapter that follows.
Chapter 13: Assignment of Income

Introduction

13.1 Questions that are considered under this heading concern the tax consequences for assignor and assignee where the assignor has transferred to an assignee his interest in future receipts that would have been income of the assignor had he not transferred his interest in them. It is assumed that the assignor has effectively transferred his interest so that at least an equitable remedy will be available to the assignee. In this assumption certain aspects of the operation of a substantial body of the general law are taken as given. That law draws, and attributes significance to, a number of distinctions. Thus there is a distinction between property upon which an interest in future receipts may be attendant, and the interest in those future receipts. There may be land the subject of a lease under which rent has not yet become receivable: the land may be seen as property upon which an interest in future receipts of rent is attendant and the interest in future receipts as the right to, or the expectancy of, those future receipts. Rent arises in the sense now intended when an absolute right to receive arises. At that time it ceases to be a future receipt.

13.2 A distinction is assumed in the last paragraph between an expectancy of and a right to future receipts. And the reference to future receipts assumes that there are receipts that are not future. The distinction explains the decisions in *Norman* (1963) 109 C.L.R. 9 and *Shepherd* (1965) 113 C.L.R. 385. In *Norman* the lending of money gave rise only to an expectancy of future receipts of interest, because the borrower might repay the money borrowed at any time. While the borrowing relationship subsisted interest could arise. The expectancy of future receipts would, on such arising, give place to rights to receipts, that are no longer appropriately described as future receipts. In *Shepherd* the licensing of another to exercise patent rights gave rise to a right to future receipts because the licensee could not by his own act terminate the relationship of licensor and licensee. While the licensor-licensee relationship subsisted—it might have been dissolved by the agreement of both parties—royalties arose when the licensee made use of the patent rights he had been licensed to use. The right to future receipts at that time gave rise to rights to receipts.

13.3 The distinction between expectancy of future receipts, found by the majority in *Norman*, and right to future receipts, found in *Shepherd*, may in other circumstances be difficult to draw. But this is a task of the general
law and not of income tax law. The income tax law in regard to assignments assumes the distinction drawn by the general law and attributes tax consequences which give significance to the operation of the general law. Thus, the conclusion of the general law may be that there has not been an assignment but merely a promise by a person to pay a sum of money calculated in a way that refers to a future receipt by that person. If this is so, then the promisor will be assessed on those receipts when they arise. Income tax law in relation to assignments will not result in the promisee also being taxed. However, the promisee may be taxed on other grounds. For example, in Just (1949) 23 A.L.J. 47, the High Court attributed the character of income—as an annuity—to the receipts by the taxpayer. The origin in receipts of rent by the promisor had a bearing on this characterisation ([2.206] above). But the taxpayer did not derive income as the assignee of rents.

13.4 The income tax law will attribute tax consequences which will recognise a possible principle of the general law, that an assignment which is not framed in terms of an assignment of a right to future receipts but in terms of an assignment of the future receipts themselves, can operate only to the extent that an assignment of an expectancy of future receipts will operate. Such a principle has not yet been adopted in any case, though the possibility has been suggested.

13.5 It will be helpful for the purposes of the discussions that follow to identify the concepts that emerge from the general law. The words “underlying property” identify land subject to a lease, or the patent rights subject to a licence. The words “expectancy of future receipts” identify the interest yet to arise in Norman. The words “rights to future receipts” identify the royalties yet to arise in Shepherd. The words “rights to receipts” identify interest and royalties that have arisen. The general law in regard to assignments of expectancies of future receipts, of rights to future receipts and of rights to receipts, is a substantial body of principles. Some aspects only can be the subject of attention here.

13.6 The assignment of an expectancy of future receipts without an assignment of the underlying property has consequences in equity, though only when there is value. Equity will treat the assignor as a trustee for the assignee of a future receipt when it “crystallises”, “when it is received”, “when it is derived” or “when it comes into existence”. The moment when the trust arises is described by all of these phrases in the judgment of Barwick C.J., Stephen, Mason and Wilson JJ., in the High Court in Everett (1980) 143 C.L.R. 440. The word “arises” is adopted in the present discussion to identify the moment, in order to avoid the confusions that can arise from the use of the word “accrues”. The word accrues is used in
statements of equity principles that have distinct functions, for example, in determining the appropriate distribution of trust income between successive life tenants. And the assumption is made that a future receipt “arises”, “crystallises” or “comes into existence” when it becomes presently receivable. Some assumption has to be made, and presently receivable has the advantage of simplicity. Tax law would no doubt follow the general law if the general law were to adopt another test of when a future receipt becomes present property. Tax law and the general law would to this extent become more complex, but would remain expressions of underlying principles that would not need to change.

13.7 An assignment of an expectancy of future receipts, which may be implicit in an assignment of underlying property, is carried by the assignment of the underlying property. In *Everett* the expectancy of future receipts of partnership income by the holder of a share in a partnership was held to be carried by the assignment of the partnership share, so that the law in regard to the effect in equity of an assignment of an expectancy of future receipts had no relevance. Barwick C.J., Stephen, Mason and Wilson JJ. said (at 452): “The consequence in the present case is that because the [taxpayer] assigned present property, a chose in action, being a share of his interest in the partnership which carried with in the right to a proportionate share of future income attributable to his interest, the assignment became effective at once and conferred on his wife an immediate equitable entitlement as against the respondent and the other partners to such income referable to the share assigned as might subsequently be derived.” The phrase “right to a proportionate share of future income” is to be understood in the context of the analysis adopted in the judgment which would regard the interest in profit given by a partnership share as an aspect of the rights which make up the partnership share. This analysis explains the view expressed in the judgment (at 450) that “a partner's entitlement to participate in profits is not separate and severable from the interest of the partner.” Independently of the specified share, an interest in future profits of a partnership is no more than an expectancy.

13.8 There is considerable discussion in *Everett* (1980) 143 C.L.R. 440 at 453 and other authorities of a proposition that “income from personal exertion cannot be assigned so that it is not first received as income by the assignor.” The judgment of Barwick C.J., Stephen, Mason and Wilson JJ. insists that the proposition is not a proposition of equity. If an interest in future receipts arising from personal exertion is not an aspect of some underlying property such as a share in a partnership, it will none the less be capable of assignment in equity to the extent that any expectancy is capable of assignment. When the future receipt arises it may be received as
income by the assignor, independently of the assignment if he is on an
accruals basis of tax accounting in relation to the item, or by the operation
of the assignment if he is on a cash basis. But the operation of equity,
where there has been value, in making the assignor trustee for the assignee
immediately the receipt arises depends on principles of equity, not tax law.

13.9 Where an assignment operates by equity making the assignor trustee
for the assignee immediately a receipt arises, there is a receipt of corpus by
the trustee and not a receipt of income. There is therefore no room for the
operation of any of the provisions of Div. 6 of Pt III so as to bring on tax
consequences for the beneficiary assignee. The authority is an observation
in the judgment of Barwick C.J., Stephen, Mason and Wilson JJ. in
*Everett*, made in relation to the judgment of Kitto J. in *Stewart Dawson
Holdings Pty Ltd* (1965) 39 A.L.J.R. 300. The observation made in *Everett*
is (at 452):

“The . . . contention is that the income payable to the respondent's wife was not as
the majority in the Federal Court held, ‘the net income of a trust estate’ within the
meaning of s. 95 of the Act. The argument is based very largely on the proposition,
founded on the judgment of Kitto J. in *Stewart Dawson Holdings Pty Ltd . . .* (1965)
39 A.L.J.R. 300, at 301, that income derived by a trustee from his own property or
by means of his personal exertion, ‘income with respect to which a trust arises at the
moment of derivation’, does not answer the statutory description. Kitto J. was
making the point that when a person establishes a trust of his future income
simpliciter, the income when it is derived is the subject matter or corpus of the trust,
not the fruit of it. To use the terminology of s. 95, it is because the income is the
‘trust estate’ that it cannot be ‘the net income of’ that trust estate. His Honour's
remarks do not touch the case where an immediate trust is established of a
proprietary right which yields or earns future income. Then the income is accurately
described as income of a trust estate. For reasons which we have already given, this
is the situation which obtains here.”

13.10 This observation perpetuates a view of the meaning of “trust estate”
in Div. 6 of Pt III, which, in the view of this Volume, is inconsistent with
some of the provisions of that Division and has unacceptable consequences
([2.233] and [4.88] above). But in other respects it asserts a principle which
is important both for trust law and tax law. The character of a receipt as
income must be judged in the circumstances of its derivation by the
77 A.T.C. 4255 is a strong expression of that principle. There is however
an observation in the judgment of Bowen C.J. in that case that may be
thought to weaken the principle in the context of non-business receipts.
Bowen C.J. said (at 4264):

“It may be possible to envisage a case where, for example, the subject of a gift
would seem to have in its origin, the essential character of income and to retain that
c Character in the hands of a donee. The case of a transfer without consideration of a
 payment of future interest on debentures might be regarded as such a case. But there
the essential income character of the receipt, which would lie in its being the
produce of a capital investment coming forward in a series of periodic payments,
would remain unchanged in the hands of the donee.”

Bowen C.J. did not assert a principle applicable to all assignments of investment
income. The reference to a “gift” indicates he did not have in mind the assignment of
an expectancy, for such an assignment has no operation unless there is value. The case
that Bowen C.J. thought it might be possible to envisage is the assignment of rights to
future receipts. If such receipts, when they arise, do not become income of the
assignee, there is a “swallowing” of income which is unacceptable.

13.11 Where there has been an assignment of a right to future receipts that
would have been income of the assignor, receipts by the assignee under the
assignment are his income as gains derived from his property, the property
being the right to future receipts. If the reasoning appears forced, it is none
the less essential to the coherence of income tax law. And it should be
noted that the reasoning is at least suggested, if not directed, by the
analysis adopted by Kitto J. in Shepherd (1965) 113 C.L.R. 385 to explain
why there was an effective assignment in that case, notwithstanding that
the assignment was voluntary. He said (at 396):

“It is true also that what the appellant's right under the licence agreement would
yield in royalties in those years—indeed, whether it would yield any royalties at all
in those years—no doubt depended upon contingencies partly within the control of
Cowen. It was for him to decide how many castors, if any, he would manufacture in
accordance with the appellant's inventions and try to sell. Market conditions would
then determine how successful his efforts to sell would be. But whatever he might
do or desire to do, the existence of the appellant's contractual right would be
unaffected, though the quantum of its product might be. The tree, though not the
fruit, existed at the date of the assignment as a proprietary right of the appellant of
which he was competent to dispose; and he assigned 90 per cent um of the tree. The
case is of the general class of which Brice v. Bannister [1878], 3 Q.B.D. 569 is an
example, and may be usefully compared with Bergmann v. Macmillan (1881) 17 Ch.
D. 423 and Hughes v. Pump House Hotel Co. Ltd [1902] 2 K.B. 190.”

No doubt the notion of tree fitted the patent rights that were the subject of
the licence agreement. But the analysis of Kitto J. supplies the basis in
metaphor for a view that future receipts as they accrue to an assignee
following an assignment of rights to future receipts are fruit of a tree that is
now the property of the assignee. In any case a view of the appropriateness
of the metaphor should not control consequences in tax law: the question is
whether the receipts that arise can be income of the assignee and,
conceptually, that depends on them being gains derived from his property.

13.12 Where the assignment of rights to future receipts of an income nature
is a consequence of the assignment of underlying property—patent rights for example—receipts that arise after the assignment will clearly be income of the assignee. In this instance there can be no question but that the circumstances of derivation by the assignee give an income character.

13.13 There is, however, a difference where receipts have already arisen at the time of the assignment. A derivation by the assignee of such a receipt under an assignment which is an aspect of an assignment of underlying property, or for that matter an assignment of rights to future receipts, will not be income as a gain derived from property, though it might be income for some other reason—the assignee may have taken the assignment of receipts already arisen as a reward for services. Even when the assignee is on a cash basis, an actual receipt is no more than a derivation of a payment of a debt in which he has acquired the property by assignment: the actual receipt is not a gain derived from property. Where the assignee is on an accruals basis there is no accrual to him that would constitute a derivation by him. On the facts assumed, there would already have been a derivation by an assignor who is on an accruals basis. An assignor on a cash basis would have derived by the operation of the assignment. There is no principle that the same item cannot be derived as income by two distinct taxpayers. One may derive as a gain from property and another as a reward for services. But it does not contribute to the coherence of the law if assignor and assignee are both taxed on the same item as income derived from property.

13.14 The above discussion has drawn a distinction between the operation of the general law where an assignment of an expectancy of future receipts is made, and its operation where an assignment of rights to future receipts is made. The assignment of an expectancy has effect under the general law to the extent that when a receipt arises equity will hold the assignor to be a trustee of the receipt for the assignee. Equity will hold the assignor to be a trustee only when the assignment was made for value, irrespective of whether the assignment was made by a declaration of trust or in any other manner.

13.15 The assignment of a right to future receipts may be made without value. The manner of an effective assignment depends on whether the right is a legal or equitable chose in action. If it is a legal chose in action it may be assigned to the extent and in the manner provided at law. Where no manner of assignment is available at law, a legal chose in action is assignable in the manner required for an equitable assignment. Where a manner of assignment is available at law, but an attempted assignment in that manner is imperfectly made, equity will treat the assignment as effective in some circumstances. Thus in one formulation of principle,
equity will treat the assignment as effective if the assignor has done all that needs to be done by him to effect an assignment at law. Where a manner of assignment is available at law, but has not been complied with in an attempted assignment, equity will in any case treat the assignment as effective if there is value. In these propositions in regard to legal choses, assignment is understood in a sense that does not include a declaration of trust. A declaration of trust of a legal chose in action is effective in equity even though no value is given.

13.16 An equitable chose in action may be assigned by declaration of trust or other manner of equitable assignment, and it is not necessary that value has been given.

13.17 Where an assignment is attempted, not of an expectancy of, or a right to future receipts, but of underlying property, which carries the expectancy of, or the right to future receipts, as explained in [13.6] above, the manner of an effective assignment will be determined by the general law in regard to assignment of property of the relevant kind. The underlying property may itself be a chose in action, for example a debt on which interest arises.

13.18 Whether the assignment is of underlying property, the expectancy of future receipts or a right to future receipts, the manner of an effective assignment may involve the intervention of a trust. The effective assignment of an expectancy, save where it is carried by an assignment of underlying property, must always involve the intervention of a trust. And in some instances the assignment of underlying property will require the intervention of a trust. Thus the assignment of a partnership share requires the intervention of a trust. Everett (1980) 143 C.L.R. 440 is authority that the assignor partner becomes trustee for the assignee.

13.19 A partial assignment of a legal or equitable chose in action requires the intervention of a trust. An assignment of a legal chose in action that is defective in law but is effective in equity requires the intervention of a trust.

13.20 The preceding discussion has been an endeavour to isolate the general law as to the effectiveness of an assignment from the tax law, and raise some questions as to their interrelations. Much of the general law has been made in cases where the issue is a tax liability. Norman (1963) 109 C.L.R. 9, Shepherd (1965) 113 C.L.R. 385 and Everett (1980) 143 C.L.R. 440 are the prime examples. Everett, at least, may indicate that the general law and the tax law tend to merge in language that is not always helpful. For example, the following proposition in Everett is not helpful (at 450): “[a partner's interest] is not capable of division by assignment so that the right to participate in partnership profits which is inherent in the interest is
hived off from the rest of that interest.” It is proposed in what follows under a number of specific headings to assess the consequences in tax law of assignments which are effective at general law and to make observations where appropriate on the tax consequences of an attempted assignment that is not effective. The arrangement of headings assumes a distinction between what are called “passive” or “investment” income situations, and “active” income situations. The conclusion however will be that a distinction of this kind is unnecessary, which may be fortunate having regard to the difficulty that would be involved in drawing it. It is enough to explain the distinction by illustration. Dividends, interest, rents and royalties are passive income. Gains from business or from the supply of property or services are active income: they might be said to arise, at least in some degree, from “personal exertion”—a phrase that is featured in a number of observations in Everett. The discussion of tax consequences under the immediately following headings puts aside the possible operation of Div. 6A of Pt III (Alienation of Income for Short Periods), which may affect radically the tax consequences that would otherwise follow. Div. 6A is considered in [13.82–13.97] below.

The Assignment of an Item Presently Receivable by a Taxpayer who is on a Cash Basis

13.21 When a receivable arises there is a new right, whether the antecedent state was an expectancy or a right to future receipts. The assignment of that right will preclude any actual receipt by the taxpayer, but the operation of the assignment will bring about a constructive receipt by the taxpayer who assigns. The assignor derives in the process of assignment. Constructive receipt is an aspect of the notion of derivation by ordinary usage. The taxpayer assignor has appropriated the receivable in the act of assignment. The matter is considered in [11.144–11.149] above. It is unnecessary to call on s. 19 to find a derivation by the assignor, but that section supports the conclusion. In the case of the shareholder who assigns a dividend that has been declared, there is a difficulty posed by the language of s. 44 in its reference to “dividend paid”. Those words should be held to be satisfied by the act of assignment.

13.22 There is a question of the amount that should be taken to be derived on the assignment. A view that the amount derived is the value of the receivable at the time of the assignment has the virtue of avoiding a difference in the treatment of a taxpayer on a cash basis and a taxpayer on an accruals basis. A taxpayer on accruals holds receivables as revenue assets when they are items that should be brought to account as income.
They will be brought to account in their amounts, not their values. But he may be entitled to a deduction for a write-off, if the receivable is a bad debt. And on the assignment of a receivable he may have a deduction for a loss then realised. It is suggested in [11.41] above that a cash basis taxpayer who assigns a receivable may be put in a situation comparable to that of an accruals basis taxpayer if the amount he derives on the assignment is taken to be the value of the receivable at that time—the amount he might fairly have expected to receive had there been an actual payment to him. The value of the debt will determine the amount of income derived by the assignee if the debt is income in his hands, for example as a reward for services. If the assignee subsequently disposes of the debt, or receives payment of it, in circumstances where he is subject to tax on any profit, the value at the time of the assignment to him will generally be the cost to him for purposes of calculating the amount of his profit. The matter of cost is the subject of comment in [12.78–12.88] above.

13.23 Whatever the amount taken to be derived, it is the assignor who derives. The receivable has an income character in the hands of the assignor as a gain derived from his property—shares, debt, land or patent. The receivable does not have an income character in the hands of the assignee. The assignee simply becomes entitled to the payment of debt. Such a circumstance will not give a derivation an income character unless the assignee receives the debt as a reward for services, or in exchange for a revenue asset, or in other circumstances which concern the assignee. The character of the debt in the hands of the assignor is not retained on its assignment to the assignee. In any event, if the assignee is on an accruals basis in relation to the receivable, there is no derivation by him because there is no accrual to him. The notion of accrual for this purpose requires the arising of a receivable which, at the moment of arising, is receivable by the assignee. The assignee who is on a cash basis may derive on ultimate cash receipt, but what he derives does not have an income character.

13.24 Support for these propositions is to be found in the judgment of Latham C.J. in *Gair* (1944) 71 C.L.R. 388. The case concerned the assignment of a debt—underlying property—and accrued interest. The issue raised was the income character of a receipt by the assignee in satisfaction of rights that had been assigned to her. Latham C.J. held that the receipt could not be income derived by the assignee as a receipt of interest on the debt. At the same time he expressed a view (at 393-4) that the assignment would have brought about a derivation of interest income by the assignor, who was assumed to be on a cash basis in relation to a receipt of interest:
“I propose to consider the case in the first place upon the basis which is most favourable to the Commissioner, that is, upon the footing that the sum of £2,136 was paid to the appellant as interest due under the mortgage, and I therefore inquire whether, if this money was paid as interest, it was therefore income of the appellant.

If the money had been paid to the original mortgagee, M. J. S. Gair, there is no doubt upon this hypothesis (that is, that it was paid as interest) that it would have been part of his income. But when a right to money, which, if received by A, would have been income in A's hands, is transferred to B, it does not necessarily follow that the money when received by B will be part of B's income. If a promissory note is given to A in payment of his salary and A makes a gift of the promissory note to B, B will not receive the money paid under the promissory note as income. If X, not being a dealer in houses and land, sells his home to Y upon terms, and Y pays an instalment of the purchase money by transferring to X a right which he (Y) has to receive a sum due to him by way of salary, then, though if Y had received the salary, the money would have been part of his income, when it is received by X in part payment for the house which he has sold it is certainly not part of the income of X. He would receive merely part of the consideration for the sale of a capital asset. If Y were to deal with his salary in this way he would be liable to tax upon the amount of the salary with which he had so dealt, because the Income Tax Assessment Act 1936–1941, s. 19, provides that ‘income shall be deemed to have been derived by a person although it is not actually paid over to him but is . . . dealt with on his behalf or as he directs’. Accordingly the amount of salary would have been part of Y's assessable income, but it would not have been part of X's assessable income. Thus the same sum of money may be income in relation to one person and capital in relation to another.

If one person buys accrued rights to the payment of money, then, unless he carries on a business of dealing in such rights, he makes a capital outlay. If he pays £1,000 for the transfer of a mortgage upon which arrears of interest are due, he makes an investment of capital. Interest accrued due in the past, if it had been received by the original mortgagee, would certainly have been part of that mortgagee's income. But when the original mortgagee deals with it by transferring the right to receive it to another person, it does not follow that such interest, when received by that other person, would be part of his income. Interest which accrued due after the transfer of the mortgage would be income derived by the transferee of the mortgage and he would be taxable in respect thereof. But interest which had fully accrued due before the transfer (as distinct from interest accruing during a current period but not having become due) would not be income derived by the transferee of the mortgage. The case of the gift of a mortgage cannot, in my opinion, be differentiated in any relevant respect from the case of the purchase of a mortgage. For these reasons, I am of opinion that, even if the amount of £2,136 had been payable as interest and had been paid as interest, it would not have been income of the appellant.”

13.25 The statements of principle made by Latham C.J. are made stronger by the circumstance that the assignee had taken an assignment both of the debt for interest and of the debt for money lent—the underlying property.
The debt for interest had arisen while the underlying property was the property of the assignor—it thus had the character of a gain derived from property. It lost that character on assignment. Thereafter the link with the underlying property was historical only, and it was irrelevant who had title to that property.

13.26 Latham C.J. explained derivation by an assignor on a cash basis in the Gair circumstances in terms of the operation of s. 19. The section has such an operation unless it is read narrowly. But there is no need to call on s. 19. There is a derivation within the ordinary usage notion of derivation in the appropriation that is implicit in the assignment. The assignment gives rise to a constructive receipt.

13.27 It will be noted that Latham C.J. confined his statement of tax consequences for assignor and assignee to circumstances where interest has “fully accrued due before the transfer (as distinct from interest accruing during a current period but not having become due)”. Presumably he would not find any derivation by the assignor in the act of assignment in respect of interest referable to a current period. This would be derived in due course as interest income by the assignee. Latham C.J. thus adopts a notion of a receipt arising, both for the general law and the tax law, which is assumed in [13.6] above.

13.28 An observation in the judgment of Williams J. in Gair rejects in part the analysis of Latham C.J. Williams J. said (at 404): “But I think it is clear that, where there are arrears of interest, the whole of the arrears are income of the recipient in the year in which they are subsequently paid (Leigh v. Inland Revenue Commissioners (1928) 1 K.B. 73; cf. Champney's Executors v. I.R.C. (1934) 19 T.C. 375, at 383, 387, where Finlay J. and Lord Hanworth M.R. respectively expressed the opinion that Leigh's case was rightly decided; Dewar v. I.R.C. (1935) 2 K.B. 351, at 365–376, 369–372).” The observation is apparently intended to apply to arrears received by the creditor or by an assignee of the creditor. The references to United Kingdom authority do not establish the observation in its application to an assignee. Latham C.J. (at 395) said of Leigh v. I.R.C. that “The only question which arose was whether . . . the moneys were chargeable only when actually received”. Of another United Kingdom case, Lambe v. I.R.C. [1934] 1 K.B. 178, Latham C.J. said (at 396): “This decision does not support the contention that if a sum of money is payable at interest to A and the sum of income is in fact paid to B it follows that the money is received by B as part of his income”. Of Dewar v. I.R.C. he said (at 396): “It leaves untouched the question whether a sum of money preserves its character as interest to whomsoever it is paid.”

13.29 Gair (1944) 71 C.L.R. 388 was decided at a time when it would have
been assumed that interest will always be accounted for on a cash basis. *National Bank of N.Z. Ltd v. C.I.R. (N.Z.)* (1977) 77 A.T.C. 6001 accepts that for some taxpayers, accounting for interest on an accruals basis is appropriate. If an assignor is on an accruals basis in regard to interest, and he assigns accrued interest, a result that is wanting in good sense will follow on the analysis of Williams J. There will have been a derivation of income by the assignor on the arising of the interest, and a further derivation by the assignee on the actual receipt by him.

13.30 An attempted assignment may fail for want of compliance with general law requirements for a valid assignment, for example an attempted voluntary assignment of a legal chose may be defective in the manner of the assignment to a degree that is beyond the power of equity to correct. The attempted assignment cannot have any of the tax consequences so far examined. However an aspect of an attempted assignment may be a mandate given to the debtor to pay the amount of the debt to the assignee. If that mandate is acted on by the debtor there will be a derivation by the would-be assignor at the time of payment to the assignee. A derivation by the assignee will not have an income quality in his hands for reasons explained in relation to a receipt under an effective assignment, unless there is some aspect of the circumstances of the receipt which will give it an income quality beyond the circumstance that an actual receipt by the would-be assignor would have been income in his hands. There is a derivation by the would-be assignor in the constructive receipt by him or by the operation of s. 19. The derivation occurs at the time of payment by the debtor to the would-be assignee. There is thus an important difference between the time of derivation in this situation and the time of derivation where there is an effective assignment. The amount derived by the would-be assignor will be the actual amount received by the assignee, which may be less than the amount of the debt. Where there is an effective assignment the amount derived by the assignor will be the value of the debt if the analysis in [13.22] above is accepted.

**The Assignment of an Item Presently Receivable by a Taxpayer who is on an Accruals Basis**

13.31 The differences that may follow where the assignor is not on a cash but is on an accruals basis in relation to the receivable have been adverted to incidentally under the last heading. Where the assignor is on accruals there will have been a derivation by him at the time the receivable arose. Or, indeed, at some earlier time if, in this context, tax law will hold that there is a derivation in advance of present receivability. A subsequent
assignment by him has no tax consequences for him. The assignee will not derive any amount that is his income save where there are additional circumstances which may involve the derivation by him of income, for example, as a reward for services or as a profit from business. The fact that there will have been a derivation, prior to assignment, by the assignor who is on accruals, reinforces the conclusion that the assignee of a receivable that has arisen does not derive income on actual receipt, simply because he is assignee.

The Assignment of Rights to, or an Expectancy of, Future Receipts by a Taxpayer who is on a Cash Basis

13.32 *Shepherd* (1965) 113 C.L.R. 385 is authority that where there is an effective assignment of rights to future receipts, there will be no derivation of income by the assignor, either at the time the receipt arises or at the time when the receipt is translated into an actual receipt. It is irrelevant whether the assignor is on a cash or on an accruals basis in relation to the receipt.

13.33 There is no authority on the question of derivation of income by the assignee. There is a policy reason why the assignee should be held to derive income, if he is on accruals, when the receipt arises, and if he is on cash, when he actually receives. If there is no derivation by the assignee, flows of income will in effect be swallowed—they will not be brought to tax in anyone's hands. There is a basis of distinguishing the situation of an assignee of a receivable that has arisen, who does not derive income, and the situation of an assignee of a right to a future receipt that thereafter arises. In the latter situation, property, in the form of the rights to the future receipts, has been assigned to the assignee, and the circumstances of derivation by the assignee give an income character to each receipt as a gain derived from that property. This analysis is supported by the analysis offered by Kitto J. in *Shepherd* to explain the difference between an assignment of expectancies and an assignment of rights to future receipts. The assignment of rights to future receipts attracts the metaphor of a tree that bears fruit as receipts subsequently arise.

13.34 An attempted assignment of rights to future receipts that fails for want of compliance with the general law requirements for a valid assignment, will leave the rights in the would-be assignor who will derive income on the subsequent arising of a receivable, if he is on an accruals basis in relation to that receivable. If, as an aspect of an attempted assignment, a mandate has been given to the debtor to pay the amount of the debt to the would-be assignee, action by the debtor on that mandate subsequent to the arising of the receivable will not have any tax
consequences for the assignor. If the assignor is on a cash basis, however, the action by the debtor will give rise to a constructive receipt that is a derivation, or to a derivation by force of s. 19. The would-be assignee will not derive income on payment to him.

13.35 The assignment of an expectancy of future receipts by a taxpayer who is on a cash basis in relation to those receipts raises difficult issues. There is authority that the assignment will not prevent the derivation of income by the assignor at the time the receipt arises. Norman (1963) 109 C.L.R. 9 is not direct authority. The case is simply a decision that the attempted assignment was ineffective under the general law, because there had been an attempt to make a voluntary assignment of the expectancy. But observations in the case suggest that if there had been value, the assignor would yet have remained subject to tax on receipts as they arose. The cases referred to in Everett (1980) 143 C.L.R. 440 at 453 holding that the assignment of employment income will not prevent derivation by the employee are relevant authorities (Spratt v. C.I.R. (N.Z.) [1964] N.Z.L.R. 272; Peate (1964) 111 C.L.R. 443 at 446; Parkins v. Warwick (1943) 25 T.C. 419 at 424; Kelly v. C.I.R. (N.Z.) (1969) 1 A.T.R. 380 at 384). The analysis that warrants the conclusion that an assignor who has effectively assigned remains subject to tax on receipts as they arise is not immediately evident. The analysis has to be drawn out from an observation by Dixon C.J. in Norman and another by Barwick C.J., Stephen, Mason and Wilson JJ. in Everett. The observation by Dixon C.J. in Norman (at 15–16) relates to an attempted assignment of an expectancy of future receipts of dividends:

“Under s. 44 of the Income Tax and Social Services Contribution Assessment Act it is provided that the assessable income of a shareholder in a company shall include dividends paid to him by the company out of profits derived by it from any source, if he is a resident, and if he is a non-resident, from sources in Australia. If the shareholder is a trustee, no doubt the operation of Div. 6 [of Pt III] may protect him, but the taxpayer in the present case was not in that category. It seems to me somewhat difficult to know why he should not be liable to include the dividends . . . .

So far as the dividend is concerned, I think the structure of s. 44 of the Income Tax and Social Services Contribution Assessment Act 1936–1958 makes it impossible that future undeclared dividends should be assigned by the shareholder so as to exclude him from liability to include the dividends when declared in his assessable income. Section 44 and the sections which follow are framed to deal specially with the case of members of companies who are entitled to dividends. The whole question of tax upon the profits of companies is dealt with specially in the Act, including the scheme relating to rebates. It would become impossible if a shareholder could without transferring his shares assign a future undeclared dividend so as to exclude the operation of the provisions.”
The observation is a blend of argument in policy—“It would become
impossible if”—and an argument that rests on the “structure of s. 44”. Save
where the shareholder is a trustee of his shares, when Div. 6 of Pt III will
operate, s. 44 directs that a dividend paid to a shareholder is income of the
shareholder. The direction is not, however, to be seen as some special
provision in regard to dividends from which may be drawn an inference
that a contrary principle may apply in regard to other expectancies. The
direction reflects a principle applicable to any expectancy. The principle is
recognised in the judgment of Barwick C.J., Stephen, Mason and Wilson
JJ. in *Everett* where it is said that (at 449–450):

“Consequently, we are unable to agree with the appellant's submission, based on
the dissenting judgment of Deane J., that the right to receive profits is separate from
the partner's interest in the partnership as such. We do not doubt that a partner may
enter into a contract or otherwise bind himself to deal with his future profits from the
partnership so that others may acquire enforceable rights to those profits as and
when they are derived. Whether he can sever his entitlement to receive future profits
from his interest in the partnership so as to confer an immediate entitlement on an
assignee with respect to those profits as distinct from assigning future profits and
thereby binding those profits if and when they arise, is another question. . . . The
fundamental consideration, as we see it, is that the partner's fractional interest is an
entire chose in action; it is capable of division by assignment into further fractions,
but it is not capable of division by assignment so that the right to participate in
partnership profits which is inherent in the interest is hived off from the rest of that
interest. Consequently, a partner's entitlement to participate in profits is not separate
and severable from the interest of the partner.”

“Right” may not be the appropriate word when a reference is made to
the interest of a person to share in the income of a partnership. But the
import of the judgment is clearly that an assignment of an interest of a
person to share in income of a partnership without an assignment of the
partnership share is an assignment of an expectancy of a receipt that cannot
prevent a derivation of income by the assignor when the receipt arises, at
which time there is an actual or constructive receipt by him.

13.36 The manner of operation of an effective assignment of an
expectancy, be it an expectancy of a dividend, a profit of a partnership or
any other, is the fixing of a trust on the item when it arises so that the
assignor holds as trustee for the assignee. Where the assignor is on a cash
basis the fixing of a trust under the assignment has the same tax
consequence as the operation of an assignment of an item that has already
arisen. That operation, it was explained in [13.21] above, is to bring about
a derivation by the assignor within the ordinary usage meaning of
derivation, supported by s. 19. A distinction could be drawn between an
assignment of an item that has already arisen, and an assignment by the
fixing of a trust that occurs at the very moment of arising of an item. But there is no reason for drawing the distinction. The fixing of the trust may be seen as bringing about a derivation of an item that has arisen in circumstances which give it an income character, whether the fixing is seen as occurring subsequent to the arising or contemporaneous with the arising.

13.37 If the assignment of an expectancy is taken to give rise to the same tax consequences for an assignor as the assignment of a receipt already arisen, it must follow as a matter of ensuring the coherence of the law that the assignment is taken to give rise to the same consequences for an assignee as the assignment of a receipt already arisen. The assignee's derivation when the amount receivable is paid to him does not have an income character unless additional circumstances give it that character, for example as a reward for services.

13.38 The assignment of an expectancy must operate by the intervention of a trust. The assignment of a receipt already arisen may not. But the intervention of a trust does not affect the ultimate tax consequences. An argument might be made, in the case for example of an assignment of future dividends, that it will be the shareholder who receives the dividend, albeit in trust for the assignee. And the conclusion might be asserted that there is a derivation by the trustee that has an income character because it arises from his shareholding. The argument confuses the status of the shareholder as an individual and his status as trustee. The operation of the assignment does not make him a shareholder as trustee. The determination of net income of the trust estate for purposes of s. 95 requires that the trustee be treated as a taxpayer, but only, it would be argued, with the qualities he has as trustee. He is not a shareholder in his capacity as trustee. The operation of the assignment does not make him a shareholder as trustee. The determination of net income of the trust estate for purposes of s. 95 requires that the trustee be treated as a taxpayer, but only, it would be argued, with the qualities he has as trustee. He is not a shareholder in his capacity as trustee.

It follows that the dividend received by the trustee is not income of the trust estate, either by force of s. 44 or the ordinary usage principle in regard to income derived from property. It is a receipt of corpus by the trustee, and is not income for tax purposes. Reference was made in [13.9] above to a passage from the judgment of Barwick C.J., Stephen, Mason, Wilson J.J. which refers to the judgment of Kitto J. in Stewart Dawson Holdings (1965) 39 A.L.J.R. 300. The view there expressed is that where there is an assignment of an expectancy and a receipt arises, to which a trust is fixed, the receipt is “the subject matter or corpus of the trust, not the fruit of it”.

13.39 The view of the tax consequences of the assignment of an expectancy taken in preceding paragraphs is in some conflict with a dictum of Bowen C.J. in the Federal Court in Everett (1978) 78 A.T.C. 4595 at 4600:

“The object of [s. 19] has been stated to be to prevent a taxpayer escaping tax
though his resources have actually been increased by the accrual of income and its transformation into some form of capital wealth or its utilisation for some purpose *(Permanent Trustee Co. of New South Wales Ltd v. F.C. of T.* (1950) 6 A.T.D. 5 at 12). In my opinion, s. 19 is not so expressed as to render an assignor liable to income tax where he has executed an assignment of income in advance for valuable consideration and either the character of the income is such that it is capable of immediate assignment or its character is such that the assignee becomes the immediate beneficial owner of it the instant it is ascertainable.”

13.40 The view of this Volume would not accord with the dictum in its application to an assignment where the “character of the income is such . . . that the assignee becomes the immediate beneficial owner of it the instant it is ascertainable”, if the intention in these words is a reference to the assignment of an expectancy. With respect, the equating by Bowen C.J. of assignments of rights to future receipts and assignments of expectancies cannot stand with the judgment of the High Court on the further appeal in *Everett* (1980) 143 C.L.R. 440. The judges of the High Court were at pains to explain that it was not significant that income of a partnership in which individual interests may arise might in some sense be described as income from personal exertion. They were responding to a proposition put to them by counsel that “income from personal exertion cannot be assigned so that it is not first received as income by the assignor”. Their further comments on that proposition afford at least a strong basis of inference that where there is no more than an expectancy of a future receipt arising from personal exertion, an assignment will involve a derivation of income by the assignor. *Everett* was not such a case.

13.41 Where an attempted assignment of an expectancy of future receipts fails to have effect—it may have been voluntary—the attempted assignment may none the less operate as a mandate. The tax consequences are those that attend a defective assignment of a right to future receipts which may operate as a mandate. They are considered in [13.34] above.

The Assignment of Rights to, or an Expectancy of, Future Receipts by a Taxpayer who is on an Accruals Basis

13.42 An assignment of rights to future receipts will prevent a derivation of income by the assignor on subsequent arising of receipts, whether the assignor is on accruals or cash. An assignment of an expectancy of future receipts where the taxpayer is on accruals will have the same consequences, in substance, as an assignment by a taxpayer on cash. Where the taxpayer is on accruals, there will be a derivation of income by him on the arising of a receipt irrespective of the immediate operation of
the assignment to fix a trust on that receipt. The fixing of the trust does not involve a further derivation.

13.43 Where there is a defective assignment there will be a derivation by the would-be assignor the moment a receipt arises. The fact that action is taken thereafter on a mandate that was an aspect of the attempted assignment, will not produce tax consequences for the assignor.

The Assignment of Active Income

13.44 The distinction between passive income and active income was drawn in broad terms in [13.20] above. In the view of this Volume it is unnecessary for present purposes to draw a precise distinction, since tax consequences are affected not by the passive or active character of the income, but by the general law character of the subject of the assignment expressed in terms of receipts that have arisen, rights to future receipts, expectancy of future receipts and underlying property. The fact that an item of receipt might be described as active income has significance only in the resulting likelihood that, if it is a future receipt, it is an item about which there can only be an expectancy. There can only be an expectancy of future wages. There can only be an expectancy of a future receipt in respect of services or goods supplied by a taxpayer engaged in business. There can only be an expectancy of a future receipt, that may be income to the extent of a profit, in respect of the disposition of property.

13.45 The principles explained in preceding paragraphs as applicable to passive income are thus the principles applicable to active income. There may be very little room for principles that relate to rights to future receipts where the income is active income. But there may be some. The taxpayer in London Australia Investment Co. Ltd (1977) 138 C.L.R. 106 may be said to have been deriving active income in the form of interest on debentures. At least in the view of Gibbs J., it was engaged in a business of switching investments to secure the maximum return in dividends and interest. The tax consequences of assignment of that interest, if the debentures were not subject to the debtor's privilege to repay the loan as in Norman (1963) 109 C.L.R. 9, would be the tax consequences of the assignment of a right to future interest.

13.46 There is a good deal of judicial authority on what is referred to as the assignment of “personal exertion” income. Some of that authority tends to suggest that the quality of receipts as receipts for personal exertion precludes the making of an assignment that will prevent the receipt being income derived by the person who engaged in the personal exertion. Where the personal exertion is performed in the context of a contract of
employment, the authority comes near to expressing a public policy that salary and wages cannot be assigned. One would have thought that any policy of that kind would be a policy of the general law and not of tax law, though the judgment of Barwick C.J., Stephen, Mason and Wilson JJ. in Everett (1980) 143 C.L.R. 440 approaches it as a policy of tax law. If it is the latter, it is curious indeed. It would assert that the Commissioner can afford the loss of revenue that may flow from income splitting by assignment of income by the self-employed, but not the much greater loss if the mass of the employed were to be able to engage in income splitting in relation to their wages and salaries. Thus employees must be discriminated against.

13.47 The High Court in Everett did not definitively reject a principle that would reflect such a policy. But it explained the distinction between those cases where such a principle seems to have been expressed and the circumstances of Everett, in a way that justifies the view taken in this Volume. That view is that the only relevant distinction is one drawn between an assignment of an expectancy of future receipts, and an assignment of rights to future receipts or of underlying property on which future receipts may attend. The court said (at 454):

“Whatever be its true and its precise limits, we do not consider that the principle applies here. The income of the respondent from the partnership was not income from personal exertion in the sense in which that expression has been used in the cases. There, with the exception of Kelly's case ((1969) 1 A.T.R. 380), it has been usually employed to signify income by way of wages or salary under a contract of employment where the contractual right to receive the income has been incapable of present assignment. It would also apply to the income earned by a sole trader who operates a business and a professional man who practises on his own account. In this context it is correct to say that the taxpayer's remuneration is the product of his personal exertion and that all that he has to assign are his future receipts as distinct from any right to receive those receipts.”

13.48 The propositions asserted in [13.44] above that there can only be expectancies of, and never rights to, future wages, future receipts for services and future receipts for goods supplied, calls for explanation. There is one factor common to all these receipts. None of them will arise unless some affirmative action is taken by the person who will be entitled to the receipt. The arising of a receipt is contingent on that affirmative action. A conclusion that this factor ensures that the receipt can only be an expectancy may be drawn from the passage just quoted from the judgment in Everett.

13.49 The law which will determine whether a future receipt is a matter of right or expectancy is by no means definitive. It is not enough to make a
future receipt an expectancy that the contract under which it may arise may be terminated by the bilateral action of the parties. A power in the person on whom the correlative liability will rest to terminate the contract under which the liability may arise otherwise than by repudiation, will, it seems, be sufficient to make the receipt an expectancy only. Norman (1963) 109 C.L.R. 9 may be taken to have decided as much. But a power in the person on whom the liability will rest to prevent an arising of a receipt by abstaining from action within the contract, will not make the receipt an expectancy. Shepherd (1965) 113 C.L.R. 385 is authority for this proposition. If the proposition in the last paragraph is accepted, affirmative action by the person in whose favour the receipt will arise will have different significance from the failure to act by the person on whom the liability will rest.

The Assignment of Dividend Income

13.50 The preceding general discussion will have indicated the issues that arise in relation to the derivation of a dividend in circumstances where (i) a dividend that has arisen has been assigned, either separately or together with the shares; (ii) an expectancy of a future dividend has been assigned; and (iii) shares, carrying the expectancy of future dividends have been assigned. The resolution of these issues will be affected by the operation of the provisions of the articles of association of the company in regard to the payment of dividends. The articles may be drafted in such a way that a dividend may arise on the ascertainment of profits without any exercise of discretion by the directors or by the general meeting to declare or pay a dividend. Most often the articles will provide for the declaration of a final dividend, by the directors or by the general meeting, in which case the dividend will arise on the making of the declaration. In the case of an interim dividend, the articles will give the directors power to pay a dividend. Such a power is exercised by the actual payment and not by a declaration, so that the arising of the dividend must wait on actual payment (Brookton Co-operative Society Ltd (1981) 147 C.L.R. 441).

13.51 The resolution of issues in relation to the derivation of a dividend will also be affected by the operation of s. 44 of the present Act which provides that: “The assessable income of a shareholder in a company . . . shall . . . include dividends paid to him by the company . . . ” The consequences of this drafting were the subject of some comment by Dixon C.J. in Norman (1963) 109 C.L.R. 9. The comment is quoted in [13.35] above. It is supported in that paragraph, though perhaps not explained, by pointing to the fact that there can be no more than an expectancy of a
dividend where it has not yet arisen—Norman is authority for this. Any assignment made before arising can operate only on the arising of a dividend, and the manner of operation will be the crystallising of a trust so that the assignor will hold the dividend in trust for the assignee. The arising of the dividend and the crystallising of the trust is a derivation of the dividend by the assignor. There is no derivation of income by the assignee who is the beneficiary of the trust that receives the dividend as corpus. It must, however, be conceded that s. 44 poses difficulties for this analysis. The words “paid to a shareholder”, which on their face require action by the company, must be given a wide construction if they are to include an ordinary usage derivation by a shareholder by way of a constructive receipt. The word “paid” is given an extended meaning in s. 6, by which “ ‘paid’ in relation to a dividend includes credited or distributed”. But the act of declaration of a dividend standing alone is not, it seems, a crediting. If it were all taxpayers would in effect be on an accrual basis in regard to dividends.

13.52 If a narrow construction is given to the words “paid to [a shareholder]”, and they are treated as determining exclusively when a dividend is to be taken to be derived by a shareholder, an assignment of an expectancy of a dividend may achieve an income swallow. There will be no derivation of the dividend by the assignor, because the dividend will not at any stage be paid to him in his own right, unless the dividend is an interim dividend which arises only on actual payment to the shareholder. In the interim dividend situation payment to the assignor in his own right might be said to occur at the same moment as the trust crystallises in favour of the assignee. But payment of a final dividend that has been declared will be made to the shareholder as trustee for the assignee, and this is not a derivation by the shareholder in his own right. A payment to the shareholder as trustee is not a payment of a dividend to the trust estate. The view taken in this Volume is that the trustee receives payment of a debt owed to the trustee as a consequence of the assignment and the receipt is a receipt of corpus by the trust.

13.53 There is an evident need for the redrafting of s. 44 so that it will refer to dividends derived by a shareholder. The ordinary usage notion of derivation will thus govern. The meaning of “paid” in the definition in s. 6 for purposes of the phrase “paid out of profits” in s. 44, should be extended to include declared, and the language of the definition of dividend in s. 6 should be reframed so that it will embrace a declaration. The meaning of paid for the purposes of the making of a sufficient distribution (s. 105A) should not be extended. Indeed it is already too wide. If crediting is not enough to constitute a derivation by a cash basis taxpayer, there is a
prospect of action by a company that will be a sufficient distribution though there is no derivation by shareholders on a cash basis.

13.54 It may now be appropriate to state the consequences of an assignment in the situations listed in [13.50] above on the assumption that the redrafting of the specific statutory provisions for which there is an evident need, has been made. Where a dividend that has arisen—a dividend validly declared—is assigned by a taxpayer on a cash basis, whether separately or together with the shares, there will be a derivation of income by the assignor in the operation of the assignment. The operation of the assignment will follow that appropriate to a right to a present receipt. There will be no derivation of income by the assignee.

13.55 Where an expectancy of a future dividend has been assigned without the shares, there will be a derivation of income by the assignor when a dividend arises. There will be no derivation by the assignee.

13.56 Where shares carrying an expectancy of future dividends are assigned there will be no income derived by the assignor. Future dividends as they arise will be income of the assignee. In this situation there is a prospect that a dividend will arise and be paid to the assignor before the assignee has been entered on the register as a shareholder. In these circumstances the assignor should be treated as a trustee for the assignee, in relation both to his status as shareholder and to the derivation of the dividend. There will thus be income of the trust estate, that is income of the assignee under s. 97.

The Diversion of Income by a Stipulation for a Payment to be made to Another

13.57 The general law implications of a stipulation in a contract entered into between A and B, whereby it is provided that B will make a payment or payments to C, remain less than firmly settled. The most recent United Kingdom and Australian decisions raising the implications on a wide front are Beswick v. Beswick [1968] A.C. 58, and Coulls v. Bagot's Executor & Trustee Co. Ltd (1967) 119 C.L.R. 460. Those cases may justify the following statement of principle:

(1) Where A contracts for himself and not as trustee for C, and the stipulation is not to be construed as a revocable mandate given by A to B, neither A nor C is entitled to recover the amount that B has agreed to pay to C. A may be entitled to recover damages from B, if B fails to pay to C, but in most circumstances the amount of damages will be nominal. A may obtain an order for specific performance of B's promise to pay C. A might agree with B to modify, compromise or discharge further performance by B, and C would have no right to complain. If A in fact receives a
payment from B, he must account as trustee to C.

(2) Where A contracts as trustee for C, A as trustee may recover the amount B has agreed to pay to C, and is bound to recover. He must account to C for what he recovers. A has no right to modify, compromise or discharge further performance by B.

(3) Where the stipulation is construed as a revocable mandate given by A to B, A may revoke the mandate and recover from B, and is not bound to account to C.

13.58 It may in theory be possible to construe a stipulation as one that embodies two transactions, a contract for a payment by B to A which may give rise to an expectancy of, or a right to a payment in A, and an assignment of the expectancy or right to that payment to C. Such a construction was suggested to the court but not adopted in Coulls v. Bagot's Executor. If it is a proper construction, the discussion of assignment situations in previous paragraphs becomes relevant. The principles and conclusions will not differ from those applicable where an assignment is made of an already existing expectancy of, or right to, future receipts.

13.59 Where the stipulation is within (3) above—it is taken to be a revocable mandate given by A to B authorising a payment by B to C of an amount owed by B to A—the consequences are those already explored in relation to assignments. If the person giving the mandate is on accruals in relation to the item, there will be a derivation by him at the time of accrual, and there will be no further derivation when the mandate is acted on and a payment is made to C. If the person giving the mandate is on cash in relation to the item, there will be a derivation by him at the time the mandate is acted on by B in making a payment to C. C will derive on receipt of the payment, but the income character or otherwise of his receipt must be determined in the circumstances of that receipt. It is irrelevant what the character may be of A's receipt in A's hands.

13.60 The issues that arise when the stipulation is not to be construed as an assignment or as a revocable mandate cannot be resolved so easily. The issues that arise where A does not contract as trustee for C may be dealt with first, though, it will be seen, the issues where A contracts as trustee for C may not be materially different.

The tax consequences of a stipulation by A that B will make a payment to C

13.61 It will be assumed in the discussion that follows that the circumstances are such that a derivation by A of the item that is the payment to C would have an income character in A's hands. Thus A may grant a lease of property to B on terms that B will make payments to C. If the lease had provided for payments to be made to A, the receipts of those
payments by A would have involved the derivation of income by him. Another illustration may be drawn from the facts in *Federal Coke Co. Pty Ltd (1977) 77 A.T.C. 4255*. Reliance on *Heavy Minerals Pty Ltd (1966) 115 C.L.R. 512* might support a conclusion that a derivation by Bellambi of the amount paid to Federal Coke as a result of the stipulation by Bellambi, would have been income if derived by Bellambi, as proceeds of the realisation of a revenue asset—the supply agreement between Bellambi and Le Nickel.

13.62 The issue now raised is whether the stipulation can be seen to bring about a derivation by A, notwithstanding that the stipulation cannot be construed as an assignment by A to C of an expectancy of, or right to, the payments that are made to C. *Federal Coke* is authority that the character of the receipt by C under a stipulation of the kind now considered must be determined by the circumstances of C's receipt. The decision in the case was that the receipt by *Federal Coke* was not income in its hands. Which emphasises the prospect that there will be an income swallow if there is no derivation by A. In the other illustration of a lease under which payments are made to C, the receipts by C would not be income of C as receipts in the nature of rent, though they might be income of C as periodical receipts.

13.63 In *Federal Coke* the facts disclosed a tender of payment by Le Nickel, under what the latter took to be an earlier agreement between itself and Bellambi, the consideration for which was a relinquishment by Bellambi of its rights under the agreement for the supply of coke to Le Nickel. Bellambi refused to accept the payment, in effect claiming there had not been any such agreement. Thereafter an agreement was entered into under which payments were to be made to Federal Coke. If there had in truth been an earlier agreement, and the Commissioner had sought to assess Bellambi there would have been issues as to the income character of the amounts payable to Bellambi, and as to the derivation of those amounts. It might have been argued by the Commissioner that Bellambi was on an accruals basis in relation to the item, and had derived the whole amount provided for in the agreement on the making of the agreement. The Commissioner might alternatively have advanced arguments in terms of derivation by constructive receipt, on the assumption that Bellambi was on a cash basis in relation to the item. One of these arguments might have been made in relation to the payment refused by Bellambi, and the scope and authority of the views expressed by Gibbs J. in *Brent (1971) 125 C.L.R. 418* would have been raised. Another argument might have been that the whole amount receivable under the agreement was derived by Bellambi in the making of the new agreement with Le Nickel. That new agreement was at once an appropriation by Bellambi of the amount
receivable from Le Nickel and an application of it as consideration for a new agreement under which Le Nickel agreed to make payments to Federal Coke.

13.64 The judgments in Federal Coke (1977) 77 A.T.C. 4255 proceed on the assumption that there had not been an earlier agreement under which payments were to be made to Bellambi. There is, however, an observation by Bowen C.J. (at 4262) on the possible tax consequences for Bellambi in having entered into the agreement by which payments were to be made to Federal Coke:

“But Bellambi refused to accept the sum of $500,000. Eventually a like sum with adjustments was paid by Le Nickel to Federal in accordance with the deed of 22 March 1972. Had an assessment then been raised against Bellambi, it might perhaps have been argued that the $500,000 had accrued due to Bellambi as income and had been paid by Le Nickel to a subsidiary of Bellambi in accordance with the order and directions of Bellambi. Bellambi would then no doubt have argued that the money had not in fact accrued due to it. . . .”

The observation raises the possibility of a construction of the agreement in regard to the payment to Federal Coke so that it constituted a revocable mandate given by Bellambi to Le Nickel, with the consequence that on payment to Federal Coke there was a derivation by Bellambi. That construction of a stipulation by A that B pay to C was adverted to in [13.59] above. It is an unlikely construction. Federal Coke offers no assistance on the tax consequences of a stipulation that is not construed as a mandate, though it is evident that members of the Federal Court were conscious of the matter. Nimmo J. said at the conclusion of his judgment (at 4272):

“As the Commissioner elected to tax Federal and not Bellambi in respect of the two instalments, possible application of the provisions of sec. 19 and 260 of the Income Tax Assessment Act 1936 was not argued before us.”

Brennan J. said (at 4274):

“During argument, much was said as to the liability of Bellambi to tax in respect of the payments which Le Nickel agreed to make. Whether Bellambi is, or whether in different circumstances it might have been, liable to tax in respect of the payments made by Le Nickel are questions which do not now fall for decision. It is sufficient to say that, whatever Bellambi's liability is or might have been, Federal cannot be made to bear it.”

13.65 The difficulty in finding a derivation by constructive receipt, or by s. 19, in the operation of the stipulation, lies in the principle recognised by all members of the House of Lords in Beswick v. Beswick [1968] A.C. 58 that a stipulation which cannot be construed as a revocable mandate gives no right to A to recover the amount of the payment, if B does not in fact make the payment to C. He may recover in damages what in most circumstances will be a nominal sum, or may obtain an order for specific performance so
as to compel B to pay to C. But at no stage is A able to obtain the payment for himself. If there is in fact a receipt by him, he will hold in trust for C. Where he has not contracted as trustee for C—the situation presently being considered—he might agree with B to modify, compromise or discharge further performance by B. If he receives an amount under such an agreement he will, presumably, be entitled to retain it against C. But such an agreement will require the assent of B. It would be a significant extension of the notion of constructive receipt to find that A has derived an amount that B is under an obligation to pay to C, because he might, for some payment to himself, have discharged B from his obligation to pay C.

The tax consequences of a stipulation by A as trustee for C that B will make a payment to C

13.66 There is difficulty in finding a derivation of income by constructive receipt where A has contracted as trustee for C. It is necessary to distinguish a contract under which the consideration is provided by A in his capacity as trustee, and a contract under which it is not. A trustee, A, may grant to B a lease of trust property on terms that require the payment of a premium to C, the beneficiary of the trust. It will be assumed for purposes of this discussion that, by the operation of s. 26AB, the amount of the premium would have been included in net income of the trust estate under s. 95 had the lease called for payment to A, and the premium had been in fact paid to A. The prospect in these circumstances is that the stipulation for payment to C will be construed as a revocable mandate, and the payment to C treated as a derivation by A that will be net income of the trust estate. C will be taxed on the amount of the premium under s. 97 as a presently entitled beneficiary, or the trustee will be taxed under s. 98 in respect of C. Even if it is not construed as a revocable mandate, A's right as trustee to recover the amount of the payment, if it has not been made to C, may justify a conclusion that there has been a derivation by A that is net income of the trust estate.

13.67 Where the consideration is not given by A as trustee for C, the difficulties in finding a derivation by constructive receipt are no less than those considered in relation to circumstances where A does not contract as trustee for C. A may grant a lease of property that is not held as trust property, for a premium to be paid to C. The fact that A has a right as trustee to recover the amount of the premium if it has not been paid to C will not justify a conclusion that there has been a derivation by A that is net income of the trust estate. A receipt by A as trustee will not be given an income character by circumstances that relate to A, not to A as trustee.
This is a special application of the principle in *Federal Coke* (1977) 77 A.T.C. 4255. The circumstances that may give an income character to a receipt by a trustee are only those circumstances which concern the trustee as trustee. When s. 95 requires the determination of “net income of a trust estate as if the trustee were a taxpayer” there is to be implied in the hypothesis that the hypothetical taxpayer has only those qualities that the trustee has as trustee. These do not include the holding of the property subject to the lease.

13.68 If there is to be a derivation of income arising from the stipulation by A as trustee for C, it must be a derivation by A in his own right, and the difficulties in finding such a derivation are perhaps greater than where he does not contract as trustee. It is true that A who contracts as trustee in regard to the promise of payment by B, may recover from B if B does not pay C. But whatever he recovers he holds in trust for C. And he is not free to modify, compromise or discharge further performance by B.

**The possible tax consequence that there is no derivation of income by any person**

13.69 There is then a prospect that a stipulation requiring payment to another may be held, in some circumstances, to achieve an income swallow. What would have been income of the person making the stipulation, had the stipulation provided for payment to that person, is in the outcome not the income of any person. There is need of express provision to bring about a derivation of income, either by the person who makes the stipulation or by the person who receives the payment. The express provision would have some affinity with s. 26(e), with which indeed it would need to be correlated. Where A renders services to B in return for a promise of payment to C, s. 26(e) will treat as income the value to A of any benefit that A enjoys as a result of the payment to C. Section 26(e) is considered in [2.367]ff. and [4.38]ff. above and in a number of other contexts. Its operation in precluding an income swallow is limited by the need to show benefit to the taxpayer who makes the stipulation. This benefit is likely to be confined to a saving of expense, for example in the maintaining of a wife or child, that may be regarded as resulting from the fact that money is paid to another person—the child's school or the wife herself. Section 26(e) has no operation where the payment to another as a result of a stipulation by the taxpayer does not involve a benefit to the taxpayer, where, for example, the relative to whom the payment is made is adult and living independently of the taxpayer. Section 26(e) is in any case limited in its operation to benefits that are the product of services rendered by the taxpayer, and what protection it affords against income swallows is
therefore available only on a narrow front.

13.70 There is need of a wider provision. That provision might in one respect follow the model of s. 26AAC, to which reference is made in [4.85] above. That section displaces the principle in Federal Coke (1977) 77 A.T.C. 4255 and may give an income quality to the receipt by the person to whom the payment was made: an acquisition of shares or options over shares may be income derived by a taxpayer, where the acquisition was “in respect of, or for or in relation directly or indirectly to, any employment of, or services rendered by . . . a relative of the taxpayer” (s. 26AAC(1)). The wider provision should extend to all circumstances where the derivation by a person may be said to be in respect of or for or in relation to any process that would have given an income quality to a like derivation by another. It would, however, be limited to the excess of the amount of the derivation, over the value any benefit from that derivation that is income of that other. The wider provision should not be applicable where the derivation is a consequence of an assignment of a right to or an expectancy of a future receipt or of a receipt that has arisen.

13.71 Section 26AAC is not confined to circumstances where the shares or options acquired by the taxpayer were acquired under a stipulation in a contract of employment, or a contract for the rendering of services, entered into by a relative. The wider provision now proposed should follow s. 26AAC in not being confined to stipulation situations. The wider provision should be drafted so as to overcome the narrow interpretation of the words “allowed given or granted . . . in respect of, or for or in relation directly or indirectly to, any employment of or services rendered” in s. 26(e), which would appear to flow from Constable (1952) 86 C.L.R. 402. Payments in that case by an employer could not be traced into receipts by an employee when there was an intervening exercise of discretion by the trustee of a superannuation fund.

The Tax Consequences of a Purported Assignment of “Net” Receipts

13.72 A purported assignment of the “net rents” from a building owned by the taxpayer must relate to some defined period, possibly a period of one year. If it cannot be related to a defined period, it is difficult to see what operation might be given to the purported assignment. If it does relate to a defined period, the most likely construction is that the taxpayer has promised to pay a sum of money calculated in a particular way. There is no assignment of an expectancy of, or a right to, future receipts. In the view of Owen J. such a construction was attracted by the words used in Shepherd
(1965) 113 C.L.R. 385 though other members of the court found that there had been an assignment. In *Shepherd* the words used expressed a stated fraction of future gross receipts. Where the words used refer to “net” receipts and thus require the subtraction of expenses over a period to determine the amount of receipts to which the would-be assignee is entitled, a construction that the taxpayer has merely promised to pay a sum of money calculated in a particular way is compelling. A view of the transaction that it is an assignment of part of the future receipts is not open, since the determination of the amount of any receipt that is assigned must wait on the expiration of the period. Only then call all the expenses be known. The subject matter of the trust that must intervene in the operation of an assignment of part of a right to future receipts, or on the assignment of an expectancy of future receipts, cannot be identified in the circumstances of a purported assignment of “net rents”. What is true of “net rents” must be equally true of any other purported assignment that relates to “net” future receipts.

**The Effect of an Assignment of Underlying Property**

13.73 A person assigns a debt bearing interest at a time when interest on the debt has not yet become presently receivable. The assignment of the debt will carry the claim to future interest. Whether the claim was an expectancy of future interest or a right to future interest, there will be no derivation of income by the assignor when interest arises. The arising of interest will involve a derivation of income by the assignee if he is on an accruals basis of return. If he is on a cash basis, there will be a derivation by the assignee on the actual receipt of the interest. These observations in regard to the assignment of a debt have their parallels in regard to the assignment of property subject to a lease, under which rent may arise, or the assignment of a patent subject to a licence under which royalties may arise, or the assignment of shares on which dividends may arise.

**In relation to a share in a partnership**

13.74 The foregoing has a bearing on the tax consequences of an assignment of a share in a partnership. *Everett* (1980) 143 C.L.R. 440 has treated such an assignment as an assignment of underlying property which carries with it a claim to future profits that would be no more than expectancies if the claim to them were severed from the underlying property.

13.75 Where a right to profits has already arisen because a date at which
profits are required to be determined has arrived before assignment of a
partnership share, income will already have been derived by the assignor
partner. The assignment will presumably carry the assignor's right to
profits that has already arisen. There will not be a derivation of income by
the assignee. A distribution to the assignor partner will be received by him
as trustee. The receipt will not however be net income of the trust estate.
The receipt in the distribution is corpus of the trust estate.

13.76 Where a right to profits arises after the date of the assignment, there
will not be a derivation of income by the assignor partner. So much is
decided by Everett (1980) 143 C.L.R. 440. And Everett and Galland
(1984) 84 A.T.C. 4890 are authority that generally no arising of a right to
profits occurs in the act of making the assignment. There will be an arising
in the act of assignment, which would bring about a derivation of income
by the assignor partner only where the moment of assignment is a time for
the taking of an account. It will be such if the assignment is associated with
an agreement to dissolve partnership at the time of the assignment. This
would appear to be the explanation of the Federal Court decision in Rowe
(1982) 82 A.T.C. 4243. There was an assignment and a dissolution
operative at the same moment. An agreement to dissolve requires the
taking of an account. But an assignment alone is not an occasion for the
taking of an account.

13.77 Everett is not a decision on the question whether rights to partnership
profits arise progressively over the period between partnership accounts.
There would appear to be no basis for a conclusion that they do. A number
of judicial statements bear on the matter. Thus, in Peterson (1960) 106
C.L.R. 395 at 405, Windeyer J. said:

“The date at which the profits of a partnership business are to be taken to have
accrued depends upon the date at which they were ascertained and declared, or ought
according to the partnership agreement or course of business to have been
ascertained (Hughes v. Fripp (1922) 30 C.L.R. 508, at 520, 521).”

The statement in Hughes v. Fripp to which Windeyer J. refers is the following
statement of Starke J.:

“If the profits of a partnership have been ascertained and declared before a
testator's death, or ought, according to the agreement or course of business of the
partners, to have been ascertained before, but are not in fact ascertained till some
time after, the testator's death, then those profits are treated as part of the corpus of
the testator's estate.”

A view that the assignment of a partnership share between partnership accounting
dates will prevent the assignor deriving income representing profits since the last
accounting date, is at least suggested by Williams J. in Happ (1952) 9 A.T.D. 447.
The case concerned an agreement by which two partners assigned their shares to the
two other partners, and all the partners agreed to a dissolution of partnership operative at a date some time before the agreement. Williams J. held these circumstances gave rise to an arising of rights to profits in all four partners at the date of the agreement to dissolve. In this there is an assertion of the principle that an agreement to dissolve requires a partnership account and is a moment of arising of rights to partnership profits. The provision for retrospective dissolution did no more than effect a disposition of the assigning partners' interests in profits referable to the period from the date of the asserted retrospective dissolution to the date of the agreement. But it had no tax consequences. Williams J. said (at 451):

“The agreement of 22 December 1944 varied the terms upon which the partnership could be dissolved. It effected an immediate dissolution. If the business had continued to be carried on until the end of the financial year the net income could not have been ascertained until then. But when the business was brought to a premature close the question whether net income had been earned by the partnership in the financial year depended upon the success or failure of the trading over a lesser period. The mere fact that the agreement of 22 December 1944 does not provide for any payment to the respondent in respect of his share of the net income earned up to that date does not free him from liability to pay income tax on his share of the net income that was in fact earned. It was contended that the agreement of 22 December 1944 varied the terms of the original partnership agreement in several respects, and that, inter alia, it varied the proportions in which the four partners were to share in any division of net profits made after 30 June 1944. The right to share in net profits only accrued when the accounts were taken at the end of the financial year and the net profits ascertained. Consequently the respondent and Gutkins never acquired any separate right to any net profits of the partnership because, before they acquired such a right, they had already agreed that these profits should belong exclusively to Mr and Mrs Plotke. This contention, it seems to me, overlooks the fact that the partnership was dissolved and the original business ceased on 22 December 1944. If it had continued until the end of the financial year the position might have been different. Up to the date of dissolution the partners were entitled to share the net profits equally. After that date no further profits could be made. If necessary the share of each partner in the net profits could be ascertained by taking an account. There was no legal impediment to the respondent and Gutkins assigning or releasing their share of the net profits to Mr and Mrs Plotke. But they were disposing of property which was their assessable income under the provisions of ss. 90 and 92 of the Income Tax Assessment Act.”

The judgment is at least consistent with a view that rights to partnership profits arise only when a partnership account falls to be taken. If there is an assignment of a partnership share prior to that time, rights to profits will arise in accordance with the shares in the partnership obtaining at the date at which the account is taken (Galland (1984) 84 A.T.C. 4053, 4890).

13.78 The consequences of assignment of a partnership share ought not to be any different from the consequences of an agreement between partners which will effect changes in their partnership shares. There is a redefinition of underlying property which ought not to be distinguished from the
assignment of underlying property in *Everett* (1980) 143 C.L.R. 440. The circumstances are different from an assignment of an interest in an expectancy of future profits which, it was agreed in *Everett*, would not prevent a derivation by the assignor on the taking of the next accounts.

**13.79** The consequences of assignment of a partnership share ought not to be any different from the consequences of a definition of a partnership share which the partnership agreement leaves to a governing partner. A governing partner may have power to fix the interests in profits of members of the partnership. Rights to partnership profits will arise in partners on the next date for the taking of accounts in accordance with the interests so determined.

**13.80** There is a difference between an assignment of a partnership share between partners, or a redefinition of partnership shares by agreement between partners, or a definition of partnership shares by a governing partner—all of which are concerned with the relative shares of persons who are partners—and an assignment of a partnership share to a person who is not a partner. Where rights to partnership profits arise at the next accounting date the derivation of income by partners will be governed by s. 92, so that there is a derivation of income at the moment rights to partnership profits arise. But the derivation of income by an assignee of a share of a partnership who is not a partner raises some difficulty. It is true that the derivation of income by the assignee will be through a trust, of which the assigning partner is trustee: *Everett* is authority that the assignment must operate through the intervention of a trust where the assignee is not a partner. But the partner trustee holding the partnership share in trust is not a partner as trustee, so that in determining the derivation of the net income of the trust estate, and derivation of income by the assignee under s. 97, there is no room for the operation of s. 92. If s. 92 does not operate, derivation by the partner trustee of net income of the trust estate may require actual receipt by the trustee. Moreover the item of income receipt will be the amount of partnership profits actually distributed, not the amount of “net income of the partnership” calculated under s. 90. And there is another consequence. If the occasion of taking a partnership account subsequent to the assignment is a dissolution of the partnership, the actual receipt will not have an income quality. It will not be a receipt derived from the partnership share. It will be a receipt in satisfaction of the partnership share itself.

**13.81** There is perhaps room for a qualification on the assertion in the last paragraph that s. 92 cannot apply in determining the derivation of net income of a trust estate, where a partner is trustee of a partnership share for an assignee of that share who is not a partner. The qualification would raise
the possibility that the partner who is trustee is a partner as trustee in a
partnership which subsists for tax purposes only. It will be noted that the
definition of partnership in s. 6 of the Assessment Act includes persons in
receipt of income jointly. It might be argued that the partner who is a
trustee is a partner as trustee in the receipt of income jointly with others
who are general law partners, so that s. 92 is applicable. The argument
might be met by a response that they are not in receipt of income jointly—
that those words are inappropriate where income is generated by business
activity.

The Operation of Division 6A of Part III—Alienation of
Income for Short Periods

13.82 The discussion so far has assumed that Div. 6A has no application to
any facts being considered. If Div. 6A does apply it will radically alter the
tax consequences of an assignment. The general law consequences of the
assignment remain, however, unaffected. The central operative provision
of Div. 6A is s. 102B(1):

“Subject to this section, where, after 22 October 1964, a right to receive income
from property is transferred, otherwise than by a will or codicil, by a person to
another person for a period that will, or may for any reason other than the death of
any person or the other person's becoming under a legal disability, terminate before
the prescribed date, any income derived from the property that is paid to, or applied
or accumulated for the benefit of, the other person by reason of the transfer, being
income that, but for the transfer, would have been included in the assessable income
of the transferor, shall be treated for the purposes of this Act as if the transfer had
not been made.”

Right to receive income from property” is defined in s. 102A(1) so that it means

“a right to have income that will or may be derived from property paid to, or
applied or accumulated for the benefit of, the person owning the right.”

The “prescribed date” is defined in the same subsection:

“ ‘the prescribed date’, in relation to a person who transfers to another person a
right to receive income from property, means the day preceding the seventh
anniversary of the date on which income from the property is first paid to, or applied
or accumulated for the benefit of, the other person by reason of the transfer.”

Two limitations on the operation of s. 102B(1) are imposed by s. 102B(2) which
provides:

“This section does not apply in relation to a transfer of a right to receive income
from property where—
(a) the right was not a right that arose from the ownership by the transferor of an interest in the property; or
(b) the right arose from the ownership by the transferor of an interest in the property and the transferor has transferred that interest to the transferee or another person.”

13.83 The effect of s. 102B(2) (b), in the language that has been adopted in [13.5] above for purposes of statements of the general law and tax law in regard to assignments, is that Div. 6A has no application to an assignment of underlying property that may carry with it expectancies of, or rights to, future receipts. Thus Div. 6A could have no application to an assignment of a partnership share that carries expectancies of future receipts of partnership profits.

13.84 A consequence of the definition of “right to receive income from property” in s. 102A(1) is in any case to exclude the operation of Div. 6A on an assignment of an expectancy of future receipts. The reference to an “owning” of a “right” by a person could not be taken to describe an expectancy. In any case, as the law has been stated in [13.32]-[13.43] above, an assignment of an expectancy of future receipts will not prevent the derivation by the assignor of a receipt when it arises. The function of Div. 6A to defeat an income shift is not called for when an expectancy is assigned. Division 6A is thus relevant only when a right to future receipts has been assigned. It is applicable to the situation found in Shepherd (1965) 113 C.L.R. 385, but not in Norman (1963) 109 C.L.R. 9.

13.85 The definition of prescribed date, and the operation of s. 102B(1) on a transfer “for a period that will, or may . . . terminate before the prescribed date”, pose a number of questions. Thus it may be asked whether it is a consequence that Div. 6A must operate, specific exceptions aside, where a loan of money, a lease of property or the licensing of patent rights extends for a period less than seven years and future receipts of interest, rent or royalties are assigned. On one view it must operate regardless of the drafting of the terms of the assignment. In particular, it must operate though the period of the assignment is expressed to be seven years from the date on which income from the property is first paid to, or applied or accumulated for the benefit of, the transferee. This view is not directly supported by any words of Div. 6A. As a matter of analysis, it requires an interpretation of s. 102B(1) such that a period of assignment terminates when all receipts to which the assignment relates that can arise have arisen. 13.86 This interpretation, however, produces the absurd consequence that at the time of an assignment it will never be possible to say of a period of assignment that it cannot terminate before the prescribed date, so that, specific exceptions aside, Div. 6A will operate on any assignment. The
prescribed date is the day preceding the seventh anniversary of the date on which income from property “is first paid to, or applied or accumulated for the benefit of” the assignee. These words do not embrace a simple arising of a receipt. They contemplate a derivation by the assignee that will qualify as an actual or constructive receipt by a cash basis taxpayer. It will be evident from the discussion in [11.122]ff. above and the decisions in Brent (1971) 125 C.L.R. 418, St Lucia Usines & Estates Co. Ltd v. Colonial Treasurer of St Lucia [1924] A.C. 508 and Permanent Trustee (1940) 6 A.T.D. 5 that such a moment of derivation may be indefinitely deferred. At the time of the assignment, it cannot be said when a derivation of income that will commence the running of the period to the prescribed date will occur. Indeed, it cannot be said for certain that it will ever occur. As a matter of analysis it must follow that, save where the lending, the lease or licence is for an infinite period, the last arising of income may occur before the expiration of the prescribed period.

13.87 An alternative interpretation would leave the possibility of some discrimination in the operation of Div. 6A. It would focus only on the period for which the right to receive income from property is expressed to be assigned. If that period is expressed so that it is for seven years or more from “the date on which income from property is first paid to, or applied or accumulated for the benefit of the [transferee]”, and that period is not subject to termination by a revocation by the assignor, the assignment is immune from the operation of Div. 6A.

13.88 The alternative interpretation may not appear to express the policy of the Division. It will allow an assignment to be effective for tax purposes notwithstanding that the right assigned may give rise to receipts for only a short period. At least, however, it does not produce an absurd result. And there will be some achievement of the policy of the Division where the right assigned can give rise to receipts for a longer period but the assignor has chosen to assign for a period that may be a short period.

13.89 The policy of Div. 6A is not in any case very evident. The broad purpose is presumably to place a control on income shifting, most commonly income shifting within a family. Under an individual unit system of income taxation imposing tax on a progressive scale, which is at least predominantly the system of income taxation in Australia, there will be an advantage for a family group if income is spread as evenly as possible over members of that group. Division 6A may be seen as directed to denying that advantage, if one member of the group has assigned income to another member of the group. The assignment for a short period presumably establishes that he wanted the tax advantage for the group that would follow. And on the kind of reasoning that underlies most of the
provisions of the Assessment Act which are directed against “tax avoidance”, including the provisions of Pt IVA considered in [16.22]ff. below, a taxpayer who sets out to obtain a tax advantage should be denied it. One can understand, even agree with, a policy that would say that income of a member of a family group should be taxed with regard to the total income of members of the group—a system of family unit taxation—but a regime such as is imposed by Div. 6A reflects some primitive, and perhaps unworthy, motive to defeat any action that may be taken with a tax advantage in mind. Tax advantages that happen to people are acceptable, those that are sought after are not.

13.90 It will be evident from the definition of “the prescribed date” that an assignment for a period of seven years from the date of the assignment will attract the operation of s. 102B. The period of the assignment may terminate earlier than the day before the seventh anniversary of the “date on which income from the property is first paid to, or applied or accumulated for the benefit of, the other person by reason of the transfer”. Though the language may suggest that the income character of an item can be found in circumstances that are independent of a person's derivation of it, the provisions must be interpreted in the context of the principle in Federal Coke Co. Pty Ltd (1977) 77 A.T.C. 4255. Interpreted in this way, the reference is to the first receipt by the assignee of an item derived from the property, that is income in his hands. It follows that a form of words that describes the period of an assignment as seven years from the first receipt by the assignee of “interest”, “rent” or “royalties” may attract the operation of s. 102B. Thus there may be interest, rent or royalty receipts that have already arisen, and are already income derived by the assignor before the assignment, or will become income derived by him by the operation of the assignment. The assignment may include such receipts. If it does, there will, arguably, be a receipt by the assignee on the receipt of the item under the assignment that will be a receipt of interest, rent or royalties, but is not a receipt by the assignee of an item that is income in his hands. It will follow that the period of the assignment will terminate before the prescribed date, and s. 102B will be attracted.

13.91 When s. 102B operates, “any income derived from the property that is paid to, or applied or accumulated for the benefit of the other person by reason of the transfer, being income that, but for the transfer, would have been included in the assessable income of the transferor, shall be treated for the purposes of [the] Act as if the transfer had not been made”. The deeming in the closing words may be thought less than is necessary to ensure a derivation of income by the transferor. There is no express provision which deems a derivation by the transferor to have occurred,
though the clear intention is that the assignor should be taken to have derived. Indeed, s. 102C in para. (b) assumes that s. 102B has operated to bring about a derivation by the assignor. It refers to an amount that is, by virtue of s. 102B, to be included in the assessable income of a person other than the assignee.

13.92 Section 102C specifies the consequences which will affect deductibility by the assignor and the derivation of income by the assignee, that follow when s. 102B has operated. Thus the assignor by s. 102C(c) is deemed to have paid to the assignee an amount equal to the amount paid to, or applied or accumulated for the benefit of the assignee, and to have paid it to the assignee, at the time it was paid to, or applied or accumulated for the benefit of the assignee, for the purpose for which the assignment was made. The assignment may have been made by way of rewarding the assignee for services the assignee had performed for the assignor. If a payment of wages or salary to the assignee would have been deductible by the assignor, the assignor will be entitled to deductions of the amounts paid to, or applied or accumulated for, the benefit of the assignee.

13.93 The operation of s. 102B(1) is to prevent those receipts by the assignee which will now be treated as income of the assignor, also being treated as income of the assignee. But the assignee may derive income by the operation of s. 102C(d). This paragraph sets up an hypothesis that an amount would have been included in the assessable income of the assignee if the assignment had not been made, and the assignor had made a payment to the assignee equal to the amount in fact derived by the assignee under the assignment, the payment having been made for the purpose for which the assignment was made. If the hypothesis is satisfied, the amount is income of the assignee by virtue of s. 102C(d). In the result receipts that are income as rewards for services, may be imputed to the assignee, where the assignment was made to reward the assignee for services.

13.94 It will be recalled ([12.25]–[12.28] above) that, in the absence of Div. 6A. an assignment of rights to future receipts made to reward an assignee for his services may involve two levels of derivation of income by the assignee. He may derive income on assignment in the amount of the value of the rights assigned, and he may derive income in the amount of each receipt as it arises and is derived by him. The assignor does not, however, derive income either on assignment or as receipts arise. The consequence of the operation of s. 102B is that the assignor derives income as each receipt arises, and, if he is on cash, is received. The assignee, however, has only one level of derivation of income, presumably as each receipt arises and is derived by him.

13.95 An assignment of a right to future receipts may have been made for
purposes of providing the assignee with “an income” in the sense of those words that emerges from the decision of the High Court in Dixon (1952) 86 C.L.R. 540 ([2.175]ff. above), so that the receipts by the assignee may be income as income derived from property and as an annuity. The fact that an item has more than one basis of income character will not make it income more than once over. And if the assignment is effective, there is no derivation of income by the assignor.

13.96 The consequence of the operation of s. 102B where the assignment has been made for the purpose of providing another with an income, may be to create two levels of derivation of income, the one by the assignor and the other by the assignee, where, if the assignment had been effective, there would have been only one. There will be derivations imputed to the assignor, and further derivations imputed to the assignee, by force of s. 102C(d). Moreover, where the purpose in the provision of an income to another is not such that s. 102C(c) will give a basis of entitlement to deductions, the assignor will not be entitled to deductions that would have effectively cancelled the imputation of income to him.

13.97 Section 102B(4) needs to be seen against this background. Section 102B does not apply where there has been an assignment of income and by reason of the proviso to para. (1) of s. 23, the income derived by the assignee would not be exempt from tax under that paragraph. Paragraph (1) prevents two levels of assessable income, the one on the husband and the second on his wife or former wife where she receives from him periodical payments in the nature of alimony or maintenance. It thus gives favoured treatment to periodical payments to a wife or former wife. The proviso to para. (1) is, however, intended to ensure that the favoured treatment does not allow what might be seen as an income swallow. In the absence of the proviso, if the husband assigns rights to future receipts as a way of providing an income to his wife the receipts arising would not be income taxed to husband or wife. The proviso ensures that there is one level of income brought to tax. The purpose of s. 102B(4) is to preserve this outcome even though the assignment is one to which s. 102B is prima facie applicable. None the less the method of drafting creates a tangle to unravel. Where a husband, for the purpose of making periodical payments of alimony or maintenance to his spouse or former spouse, has divested from himself income upon which he would otherwise have been liable to tax the proviso to para. (1) denies to the spouse or former spouse the exemption otherwise accorded by the paragraph. For this purpose, if circularity is to be avoided, the effectiveness of the diversion must be judged without the operation of Div. 6A. Section 102B(4) then prevents an operation of s. 102B and s. 102C which would defeat the purpose of requiring only one
level of tax. Those sections would result in two levels of tax. Some income shifting by a short term assignment in favour of a spouse or former spouse is thus rewarded by a successful income split. Income shifting by short term assignment is denied in other circumstances where an attempt is made to provide another with an income: in those circumstances it is penalised by the creation of two levels of income, not simply the defeat of the shift. The meaning of the words “by way of alimony or maintenance” is, therefore, of considerable importance. The Commissioner will wish to deny that the words are satisfied in circumstances where there is an amiable arrangement between husband and wife.
Chapter 14: Accounting for Trading Stock

Introduction

14.1 Tax accounting for trading stock has been explained, in [5.23]–[5.26] and [12.1]–[12.3] above, as a hybrid of accounting for receipts and outgoings, and accounting for profit or loss. The effect of s. 51 (2) is that an outlay that is the cost of trading stock is an allowable deduction. The corollary that the gross proceeds of realisation of trading stock is assessable income is, however, merely implied. Allowing a deduction of an outlay that is the cost of trading stock would bring about an unacceptable distortion in the operation of the Assessment Act, were it not for the provisions of s. 28. That section in its most common operation will negative the allowance of the deduction by bringing in a like amount as income, if the item of stock has not been disposed of by the end of the year of income. In effect, the deduction of cost is deferred till the year of income in which the stock is realised and there is a matching receipt of assessable income. In the result the taxable income comes to include a profit or loss arising from the dealing in the item of trading stock.

14.2 While this is the common operation of s. 28 where stock remains undisposed of at year end, the provisions of ss 31 and 32 allow the taxpayer, in the exercise of options open to him, in effect to anticipate a specific profit or loss. Those sections bring in as assessable income at year end, not the cost of the item but its market selling value or, in the case of trading stock other than livestock, its replacement value. In most circumstances a taxpayer will only exercise an option so as to anticipate a profit that will be his income where there is a loss carry forward that he will wish to use before the period of carry forward expires. The exercise of an option to value stock undisposed of at year end at market selling value or replacement value will anticipate a specific profit if market selling value or a replacement value is greater than cost. A taxpayer will generally wish to exercise an option to anticipate a specific loss. The anticipation of the loss will minimise his tax liability in the year of income. The exercise of an option to value stock at market selling value or replacement value will anticipate a loss whenever market selling value or replacement cost is less than cost.

14.3 The scope given by ss 28, 31 and 32 to anticipate a loss is an advantage that trading stock accounting gives to a taxpayer. No such advantage would appear to be available to a taxpayer in relation to a revenue asset that is not trading stock. Prior to amendments that followed
the decision in *Westraders* (1980) 144 C.L.R. 55, there were other advantages of trading stock accounting. As interpreted in that case, the election s. 36A gave to the old and the new interests on a change in interests in trading stock to treat the item as disposed of at cost and acquired by the new interests at cost, made possible the transfer of a potential specific loss from one taxpayer to other taxpayers. And it was assumed that a potential loss could be transferred by allowing s. 36A to operate without any election. The manner of this transferring of a potential loss is the subject of further comment in [14.69] below. Advantages arising from an election under s. 36A(2), or the operation of s. 36A without an election, have now been denied by amendments to s. 36A and s. 36.

**14.4** As against the continuing advantage of trading stock accounting over specific profit or loss accounting in the opportunity afforded to anticipate a profit or loss, a number of disadvantages for the taxpayer should be noted. A disposal of trading stock of a business that is not made in the ordinary course of business is, by force of s. 36, a deemed disposal at market value. In the language adopted in [12.99]–[12.108] above, s. 36 precludes an abortion of a dealing in trading stock by a non-business disposal which might otherwise have involved an escape from tax on a potential profit. A non-business disposal may be a way of aborting a transaction involving a revenue asset that is not trading stock.

**14.5** If an item that is trading stock of a business is realised, there will be a derivation of the proceeds of realisation, if the taxpayer is on an accruals basis in relation to the receipt of the proceeds, immediately there is a receivable of an ascertained amount that is not contingent, and this notwithstanding that there has been no actual receipt and the receivable is not presently receivable. This is the outcome of the decision in *J. Rowe & Son Pty Ltd* (1971) 124 C.L.R. 421 referred to in [11.47] above. Where the item is a revenue asset of a business but is not trading stock, the profit that is the item of income may be calculated on a profit emerging basis, which can significantly defer the derivation of income.

**14.6** Thus a conclusion that its holding of land is trading stock of its business involves the consequences for a taxpayer in the circumstances of the taxpayer in *St Hubert’s Island Pty Ltd* (1978) 138 C.L.R. 210 that a disposal not in the ordinary course of carrying on business will be a disposal at market value. It also involves the consequence that a disposal in the ordinary course of business will give rise to a derivation of income immediately on disposition, even though receipt of the proceeds of disposition is deferred. Where the land is a revenue asset but is not trading stock the first consequence is at least doubtful, and the second consequence does not follow: profit emerging accounting will apply.
14.7 Clearly, it is important to know when assets are trading stock of a business. The question is a composite one. It is of no necessary consequence that an item is trading stock in the sense that it is within the definition of trading stock or within the meaning of the word without the aid of the definition. The trading stock provisions (Subdiv. B of Div. 2 of Pt III) operate only when items that are trading stock, within the definition or that meaning, are assets of a business or were assets of a business, presumably of a continuing business. And they operate only when they are or were revenue assets of such a business. It would be to allow the definition of “trading stock” in s. 6 to deprive the word “trading” of any significance if it were held that Subdiv. B applied in relation to “anything . . . acquired . . . for purposes of manufacture”, even though the item will serve its purpose in manufacture by being plant of a manufacturing business. It is true that the concluding words of the definition— “and also includes livestock”—taken with the definition of “livestock” may be thought to support the denial of significance to the word “trading”. In a piece of convoluted drafting it is provided that the definition of livestock “does not include animals used as beasts of burden or working beast in a business other than in a business of primary production”. But the drafting is equally consistent with an assertion of the significance of the notion of trading, and the identifying of exceptions to that notion.

14.8 A reference to trading stock in the following discussions is intended as a reference to trading stock of a business. And the characterising of an item as trading stock is taken to require that the taxpayer trades or has traded in the item, save in the exceptional case of a taxpayer who is engaged in a business of primary production that includes in its assets animals used as beasts of burden or working beasts.

14.9 There remains the question as to the actual significance to be given to the word “trading”. Trading may take some of its meaning from the words “sale or exchange” in the definition of trading stock in s. 6. At least it seems to be intended that the item will at some stage be held for sale or exchange, though it may have to undergo change or manufacture to become an item presently held for sale or exchange. The definition of trading stock in s. 6, though obscurely framed, supports the Commissioner's practice of treating raw materials and part-manufactured goods that will be converted into goods held for sale or exchange as trading stock. A view was adopted by two of the judges involved in the proceedings in St Hubert's Island Pty Ltd (1978) 138 C.L.R. 210 that land is not yet trading stock until, by development, it has come to be in the form
in which it will be held for sale. In the High Court, Stephen J. (dissenting) took this view, supporting a conclusion of Mahoney J. at first instance. But the view did not prevail. It would involve unwelcome problems of timing of the deduction of cost, and the fixing of costs. Thus it might be asked whether the costs of acquisition and development would all become deductible under s. 51(1), as outgoings incurred, at the moment the item comes to be in the form in which it is intended to be sold. Section 82 would prevent a second allowance of deductions already allowed under s. 51(1). But “cost” for purposes of determining the value of closing stock would, presumably, include those costs. There would thus be a risk of some bunching of taxable income in the year in which the land comes to be in the form in which it is intended to be sold, albeit a bunching that is the consequence of taxable income having been understated in earlier years. The costs allowed in earlier years should have been treated as costs of revenue assets and not deductible.

14.10 An item that is not intended at any stage to be held for sale or exchange in the carrying on of business may be a revenue asset, but it will not be trading stock. An export licence may be an illustration. Even if sale or exchange is anticipated, it may yet be that the item is not trading stock because it is not dealt in. An item, it would be said, is not dealt in unless it is held for profit-making in the sale or exchange. It is arguable then that the assets of a life insurance or banking company that may have to be sold in the carrying on of business in order to satisfy the claims of policy holders or depositors, are not trading stock. And it is arguable that the assets of a company engaged in a business of investing of the kind found by Gibbs J. to be the business of the taxpayer in *London Australia Investment Co. Ltd* (1977) 138 C.L.R. 106, are not trading stock.

14.11 At one time it was debated whether choses in action could be trading stock. Indeed, there was a like debate in regard to land, a debate that focused on the word “anything” in the definition of trading stock. In regard to some choses in action, a more persuasive reason for exclusion may be advanced. Expenses may be incurred in activity which ultimately leads to the acquisition of a copyright: an author may be engaged in research for a book. If it be assumed that he is in business as an author, there is room to argue that the costs are costs of the copyright. But there is no asset that might be identified as trading stock in relation to which the trading stock provisions might apply until the copyright comes into existence. There is another difficulty. The author may intend either sale of the copyright or licensing another to use the copyright on payment of royalties. Do the mixed intentions deprive the copyright of any character it might have had as trading stock? If the trading stock provisions are treated as applicable
and the taxpayer does give a licence, there will be difficulty in the allowing of costs of the copyright, deferred by the operation of s. 28, against the royalty receipts. The copyright would still be “on hand”—the test of when continuing deferring of costs is appropriate. The taxpayer might achieve a result that approximates the allowance of his costs by writing down the value of the copyright by the choice under s. 31 of market selling value at year end. The written down value would serve as the value for purposes of s. 28. But this is to warp the function of s. 28.

14.12 The taxpayer who disposes of his copyright in exchange for royalties will be in a better position. The copyright, it could be said, is no longer “on hand” and deferral of the costs is no longer appropriate. Yet immediate deduction may be thought inappropriate where matching receipts will be delayed.

14.13 The conclusion is that the operation of the trading stock provisions must produce some inappropriate consequences in an area of operation outside the more elementary affairs of merchants and manufacturers. At the same time, it must be conceded, specific profit accounting does not operate in the situations envisaged in an obviously superior way. Some of the problems are considered above in [11.268]–[11.283] in relation to accounting for royalties.

14.14 Investment & Merchant Finance Corp. Ltd (1971) 125 C.L.R. 249 confirmed the application of the trading stock provisions to a taxpayer dealing in shares. The High Court thus overcame what members of the court saw as the inappropriateness of the only alternative accounting it assumed would be applicable—a basic receipts and outgoings accounting. At that time the recognition of specific profit or loss accounting had yet to become established. The application of trading stock accounting to a dealer in shares in fact facilitated dividend stripping operations and made it necessary that there be qualifications on the dividend rebate provisions by further provisions that now appear in s. 46A and s. 46B. It cannot be said that the application of specific profit or loss accounting would have defeated dividend stripping operations. The High Court might yet have insisted that dividend receipts cannot in any circumstances be regarded as proceeds of realisation of shares. But the possibility that they could be so regarded would at least have been open.

14.15 The application of trading stock accounting to the business operations of a share dealer raises other difficulties. Bonus shares, rights and options acquired by a trader in shares are additions to his trading stock. If he purchases them, they will have costs for purposes of the trading stock provisions. And if he exercises rights or options that he has purchased, the costs of the rights or options are costs of the shares acquired in their
exercise, in the same manner as the costs of raw materials become costs of finished goods. One would not treat the exercise of the options or rights as disposals of them. If one did, there would be a problem of identifying the proceeds of a disposal that should be treated as income.

14.16 More difficult questions arise when bonus shares, rights or options are acquired by the taxpayer as the holder of shares in relation to which the bonus shares, rights or options are issued. *Curran* (1974) 131 C.L.R. 409 is authority that the bonus shares, rights or options are trading stock of a share trader. *Curran* was concerned with bonus shares that, because of s. 44(2), were not in any respect income of the shareholder. The High Court held that a cost should be given to the bonus shares of the amount paid up on the shares in the course of the making of the bonus issue. It was not suggested that some part of the cost of the shares in relation to which the bonus shares were issued should be treated as a cost of the bonus shares. The decision in *Curran* allowing as a cost the amount paid up on the shares was the subject of comment in [6.194]ff., [7.24], [12.75], [12.78]ff. and [12.85] above. The effect of the decision has been overcome by the provisions of s. 6BA. The allowing of a cost is denied (s. 6BA(2)). At the same time the section, in subs. (3), gives the Commissioner a discretion to treat some part of the cost of the shares in respect of which the bonus shares were issued as a cost of the bonus shares. The provision denying the allowing of a cost does not apply where the amount that is applied in paying up the bonus shares is assessable income of the taxpayer, and he is an individual. The amount will be assessable income when it involves a crediting to the taxpayer of an amount from a revenue profit of the company. The allowing of a cost in such circumstances would follow a principle discussed in [12.84] above. A revenue asset that is received in the carrying on of a business must be given a cost of the amount that is treated as income because of the receipt. It must be so treated to prevent double taxation, or to protect an exemption from tax if the amount treated as income is exempt income. The allowance of the cost does not affect the Commissioner's discretion to attribute to the bonus shares some part of the cost of the shares in respect of which they were issued, though one might expect that the allowance of the cost will be relevant to the exercise of the Commissioner's discretion.

14.17 There is no provision equivalent to s. 6BA applicable to rights or options that are derived in the carrying on of a continuing business. Yet on the reasoning of Gibbs J. in *Curran*, costs should be attributed to rights or options received in the course of carrying on a business, even though they are not income. The view taken in this Volume is that *Curran* should be reversed by the High Court. While it remains authority there may be room
for tax planning that will exploit the implication of the decision in relation to rights or options issues. Section 6BA will not have any operation. The Commissioner could possibly call on s. 52A to neutralise the consequences of Curran by denying as a cost some part of the cost of the shares in respect of which the rights or options were issued. But the availability of s. 52A is less than obvious.

14.18 Where there is a rights or options issue, there is no express power in the Commissioner, of the kind included in s. 6BA(3), which would enable him to attribute to the rights or options some part of the cost of the shares in respect of which the rights or options were issued. The inclusion of an express power in s. 6BA(3) in relation to bonus shares might be used to base an argument that there is no power in relation to rights or options. The general trading stock provisions may in any event be too rigid to admit a principle of specific profit accounting that would allow what is in effect a spreading of the cost of the shares over those shares and the issues made in relation to them.

14.19 There is no judicial decision holding that building materials that have not yet been incorporated in a structure on real estate are trading stock of a builder. In [12.64]ff. above, building was treated as a business to which specific profit accounting was applicable, and questions were raised as to the determination of a profit emerging from a building operation. To hold that building materials are trading stock would be to attract problems of reconciling trading stock accounting and specific profit accounting that should, if possible, be avoided. The application of trading stock accounting to all aspects of the transaction involved in a building contract would be simply unacceptable. It is conceivable that building materials might be treated as trading stock up to the time when they are incorporated in a building, but the accounting on incorporation would be awkward. Section 36 might be applied on the incorporation if the incorporation could be seen as a disposal not in the ordinary course of business, so that the value at that time is brought in as income. And they could be treated as ceasing to be on hand at that time. It is a mark of the rigidity of the trading stock provisions that their operation might be triggered by the consequence of a principle of property law that a builder ceases to have property in an item when it has become part of land owned by another. And the bringing in of market value requires a fixing of that value, which in the circumstances would be onerous. A specific provision added to the trading stock provisions might require that the item should be brought in at cost. But on balance a finding that trading stock does not include materials of a builder is the most appropriate outcome.

14.20 Tax accounting in relation to spare parts that are revenue assets of a
business but are not trading stock was considered in [12.17] above. *Guinea Airways Ltd* (1950) 83 C.L.R. 584 is authority that spare parts that are held exclusively for repairs to capital assets of the taxpayer's business are not trading stock. Spare parts held by a trader who deals in spare parts are obviously trading stock. If the spare parts are held by a taxpayer whose business is to repair property belonging to others they are presumably trading stock. The definition in s. 6 is not definitive: the spare parts may not be “sold” where property in them passes under that part of the law that is concerned with contracts for labour and supply of materials. But the definition in s. 6 is not exclusive, and it may be enough to make an item trading stock that it is held for disposal in the carrying on of the taxpayer's business. The operation of s. 36 depends on disposal, which may be the moment of incorporation of the spare part in the property of another. If the repair work is carried out in a transaction that is not in the ordinary course of the taxpayer's business, there will be a deemed realisation at market value at the time of incorporation. The amount the taxpayer receives for effecting the repair will be income derived, and there is a problem of correlating this derivation with the operation of s. 36. A principle against double taxation requires some abatement of the amount received for repairs that is income, to take into account the deemed derivation under s. 36. The method of adjustment is not obvious.

**14.21** Spare parts may be held for a number of purposes, undifferentiated in relation to particular items. They may be held for repair to the taxpayer's capital assets, for sale in the ordinary course of his business as a dealer in spare parts and for disposal in a business of effecting repairs. *Guinea Airways* may suggest that one characterisation has to be made of all the spare parts held. Presumably, it is the dominant purpose in holding that will govern. If the conclusion is that the items are trading stock, there will be questions of the operation of the trading stock provisions when an item is used in effecting a repair to a capital asset belonging to the taxpayer. *Guinea Airways*, as the case is interpreted in [12.17] above, will allow a deduction of the cost of the spare part at the time that cost is consumed in effecting the repair, if the spare part is not trading stock. In the circumstances now considered the trading stock provisions must be applied. *Murphy* (1961) 106 C.L.R. 146 may be authority that there is no disposal of the trading stock until the capital asset itself is the subject of a disposal, at which stage s. 36 will apply. This is a singularly inconvenient outcome. It gives a bizarre operation to the trading stock provisions. Finding the value of a spare part in the capital asset at the time the asset is disposed of will be an impossible exercise. Whatever the authority of *Murphy* in relation to an item of trading stock that ceases to be held for sale
in the ordinary course of business but retains its separate identity, there is
good reason to conclude that the item of trading stock is disposed of when
it is incorporated into the capital asset. There will be an operation of s. 36
at that time, and a deemed cost of the same amount. That cost may be a
repair outgoing, or if an improvement or reconstruction of an entirety is
involved, an amount of cost for purposes of the depreciation provisions.

14.22 St Hubert's Island Pty Ltd (1978) 138 C.L.R. 210 includes opinions
on the questions whether acquisition for sale in the course of business is
necessary if revenue assets of a business are to be held to be trading stock.
The balance of opinions in the case is that there must be acquisition for
sale but it is not necessary that there have been repetitive acquisitions. The
land in that case had been bought for development and sale, and the case is
not authority in relation to land that may have been acquired as a capital or
a private asset and is subsequently committed as a revenue asset of a
business. In earlier discussions it has been assumed that such land may
become trading stock by being committed to the business as stock for sale.
The land will have a cost of the amount of its value at the time it is so
committed. The assumption in Whitfords Beach Pty Ltd (1982) 150 C.L.R.
355 that the trading stock provisions were not applicable gives some
support to the view that an item that is not acquired as a revenue asset
cannot be trading stock. A dealer in land who holds land acquired for sale
may receive land as a gift or by inheritance and proceed to develop the
latter with the land acquired for sale. If the land acquired by gift or
inheritance is subject to specific profit accounting, and the land acquired
for sale is subject to trading stock accounting, complexity and arbitrary
difference in outcome will result.

14.23 The English Court of Appeal decision in Mason v. Innes [1967] 2
W.L.R. 479 may stand for a proposition that a taxpayer who is on a cash
basis in relation to receipts and outgoings does not have trading stock. It is
however a decision in relation to trading stock as understood in United
Kingdom law, and its significance for Australian law is limited. There is no
express provision in the Australian law that will exclude trading stock
accounting where the taxpayer is on a cash basis. But the operation of the
trading stock provisions in these circumstances will produce some odd
consequences. Thus the taxpayer may sell stock in one year on terms that
require payment in a later year. Any deferral of cost will cease on sale
because the item is no longer on hand, but the proceeds of sale will be
income as actually received in later years. Where the revenue assets are
goods, opinions expressed in Executor Trustee & Agency Co. of S.A. Ltd v.
C. of T. (S.A.) (Carden's case) (1938) 63 C.L.R. 108 and J. Rowe & Sons
Pty Ltd (1971) 124 C.L.R. 421 leave virtually no room for cash accounting,
and the question whether cash accounting excludes characterisation of revenue assets as trading stock may not be significant. But there is room for cash accounting in relation, for example, to the copyrights which result from the work of a person in business as an author. *Mason v. Innes* involved such copyrights. If the trading stock provisions are excluded, s. 36 will be denied to the Commissioner. Questions as to the possible operation of a general principle requiring a deemed disposal at market value when a revenue asset is disposed of otherwise than in the course of carrying on business are then raised. These questions are considered in [12.21]ff. and [12.89] above.

**The Bringing in of Value at Year End**

14.24 The role of the trading stock provisions has been explained in discussion so far as providing a regime of what is, in effect, specific profit accounting, through an adapted regime of receipts and outgoings accounting. Section 28 has been explained as providing for the deferral of the cost of trading stock, deductible under subss (1) and (2) of s. 51, to the year in which the stock is realised and proceeds are an item of income. If one isolates a transaction in one item of stock from all others, subss (1) and (2) of s. 51 will allow a deduction of cost in the year of income in which the item is acquired, and s. 28 in that same year will bring in an item of income of the amount of the cost if the item remains on hand at the end of the year. The excess of closing stock over opening stock, reflecting the acquisition of the item, will be assessable income under s. 28(1). If the item is sold in the following year of income the proceeds of sale will be income and there will, in effect, be a deduction of the cost. There will in that year be opening stock of the amount of the cost and closing stock of a nil amount, since the item is no longer on hand. The excess of opening stock over closing stock is an allowable deduction under s. 28(2).

14.25 The above analysis assumes that the taxpayer has elected cost as the value of his trading on hand at year end, an election given him by ss 31 and 32. The election is in general unrestricted in regard to a choice by the taxpayer, that may be made in regard to each individual item of stock, between cost, market selling value and replacement cost, where the item is not livestock (s. 31). Where the item is livestock, the election is restricted to a choice between cost and market selling value, and a restriction precludes a change in a later year in the choice he has made save by leave of the Commissioner (ss 32 and 33). The same choice must be made in regard to all livestock.

14.26 Where an election is open to the taxpayer and is exercised so as to
substitute market selling value for cost, the effect will be to anticipate a profit or anticipate a loss which appears likely to arise when the item is realised. There is thus a departure from a general principle that the Assessment Act is concerned only with realised profits or losses. The anticipation where the item is not livestock is always in the choice of the taxpayer. Having elected market selling value at the end of one year in respect of an item whose market selling value is greater than cost, and thus anticipated a profit, he may in the following year by electing cost in respect of that item at the end of that year reverse the anticipation of profit. An election of market selling value in respect of an item whose market selling value is less than cost, will anticipate a loss, and an election of cost at the end of the following year will reverse that anticipation.

14.27 In the case of livestock, an election of market selling value will anticipate a profit or a loss. But the election once made cannot be reversed in a subsequent year save with the leave of the Commissioner. Since the election once made applies to all livestock, the taxpayer who elects market selling value is in effect required to anticipate profit or loss each year in respect of all items of livestock, unless he obtains the leave of the Commissioner to change the election he has made.

14.28 An election of replacement cost is available only in relation to trading stock other than livestock. It may have the same consequences as an election of market selling value. There will be an anticipation of profit where replacement cost is higher than cost, or an anticipation of loss where it is lower.

14.29 Regarding the term “market selling value”, Fullagar J. said in Australasian Jam Co. Pty Ltd (1953) 88 C.L.R. 23 at 31:

“(It) is not to be supposed that the expression . . . contemplates a sale on the most disadvantageous terms conceivable. It contemplates, in my opinion, a sale or sales in the ordinary course of the company's business—such sales as are in fact effected. Such expressions in such provisions must be interpreted in a common sense way with due regard to business realities, and it may well be—it is not necessary to decide the point—that, in arriving at market selling value, it is legitimate to make allowance for the fact that normal selling will take place over a period. But the supposition of a forced sale on one particular day seems to me to have no relation to business reality.”

Market selling value refers to value in the market in which the taxpayer normally sells. There may be difficulty in identifying that value where, for example, the taxpayer sells both by wholesale and retail.

The Determination of Cost

Direct costing and absorption costing
14.30 Attention was given in [12.9] above to the line of demarcation between expenses which, though associated with the acquisition of an asset, are not regarded as costs of the asset and are deductible immediately as outgoings, and expenses which are costs of the asset. The latter are not deductible as outgoings unless made so by specific provision. Under specific profit accounting they will enter the determination of a profit that is income or a loss that is deductible on realisation. Trading stock accounting in s. 51(2) has a specific provision by which outlays on stock are made outgoings. But the problem of demarcation of the line between deductible outgoings and costs of an asset in specific profit accounting, has its parallel in trading stock accounting in the demarcation of the line between expenses associated with the acquisition of an asset that need not be deferred and those that must be deferred by the operation of s. 28 as costs of the asset.

14.31 A good deal of attention has been given, most recently in *Phillip Morris Ltd* (1979) 79 A.T.C. 4352, to the determination of cost for purposes of the trading stock provisions. In *Phillip Morris* a number of United Kingdom and Australian decisions are referred to including *Duple Motor Bodies Ltd v. I.R.C.* (1961) 1 W.L.R. 739; *B.S.C. Footwear Ltd v. Ridgway* [1972] A.C. 544; *Australasian Jam Co. Pty Ltd* (1953) 88 C.L.R. 23; and *B.P. Refinery (Kwinana) Ltd* (1961) 12 A.T.D. 204. The debate reflected in these decisions concerns the extent to which expenses which are the more remote from what may be described as the “direct” costs of the item, must enter the determination of cost when cost has been elected as the value for purposes of s. 28. Treating more remote expenses as entering the determination of cost where cost has been elected will increase the deferral of outgoings under the trading stock provisions, and thus bring out a higher taxable income than would result if direct costs only entered the determination of cost.

14.32 *Phillip Morris* is authority that more remote costs may enter the determination of cost. In this it follows “absorption” costing, which financial accounting principles would allow to be appropriate in the determination of profit as an alternative to “direct” costing. Absorption costing, in the case of manufactured goods, will treat as costs not only the expenses directly related to the manufacture—the cost of raw materials, and the cost of labour that carries out operations on those materials—but also a number of costs that do not vary with the quantity of goods produced, for example the wages of inspectors, and depreciation of factory plant used in the manufacture.

14.33 No principle can set definitively what remote costs will enter the determination of cost. The cost of servicing the taxpayer's overdraft, and
the managing director's salary, have some relationship with the acquisition of goods, or the manufacture of goods. But to treat them as costs of the goods acquired or produced would be to apply a method of tax accounting to a continuing business which would be unmanageable. It is possible that all costs are to be treated as costs that must enter the determination of profit on the realisation of assets where a business is an isolated venture. *Whitfords Beach Pty Ltd* (1982) 150 C.L.R. 355 may suggest this, and such accounting, it seems, applies to a scheme within the second limb of s. 25A(1). These matters are raised in [12.40] and [12.48] above. But where there is a continuing business, neither specific profit accounting nor its equivalent in trading stock accounting, should wholly displace the operation of general receipts and outgoings accounting.

14.34 Debate about the applicability of absorption costing in regard to livestock acquired by natural increase is settled in an arbitrary fashion by s. 34(1). The taxpayer may select a cost price not being less than the appropriate minimum prescribed cost price. A price so selected cannot be the subject of a new selection except by leave of the Commissioner. The minimum prescribed prices are nominal only. The effect is that the taxpayer is under very little constraint to defer costs until realisation. Section 34(1) is, in effect, a provision giving privileged tax treatment to primary producers.

14.35 The description of the elections open to a taxpayer in preceding paragraphs omits reference to two provisions. By s. 31(2), which presumably has no application to livestock, the Commissioner may in some circumstances at the request of the taxpayer determine an amount that will be the value of trading stock at year end. The amount so determined must be less than the lowest value that could have been applicable—lower than cost, market selling price, or replacement cost. The matters to which the Commissioner is to have regard indicate that the function of the provision is to authorise a lower value where the taxpayer would not be expected to sell all the trading stock on hand in normal course of business for an amount equal to cost, market selling value or replacement cost.

14.36 There is a proviso in s. 32 whose function is not so obvious. Where a taxpayer satisfies the Commissioner that there are circumstances which justify adoption by him of some value other than cost or market selling value for the whole or part of his livestock, he may, with the leave of the Commissioner, adopt that other value.

**The identification of the cost of an item**

14.37 Where cost is applicable to determine the value of trading stock at
year end, costs of acquisition that have been incurred must in some way be identified as the costs of items of trading stock on hand at year end. Sometimes it may be possible to make an actual identification. Generally, however, there must be resort to some convention. Where a convention is likely to reflect the actual experience it will be applicable. Thus, an item of closing stock may be treated as having been acquired for a cost that is the average cost of the trading stock on hand at the beginning of the year and stock acquired during the year. A first in first out convention (F.I.F.O.) is likely to reflect actual experience, and will be attractive to the Commissioner in conditions of inflation —the items on hand at year end will be treated as the items most recently acquired and, in conditions of inflation, are likely to have the higher costs. Deferral of cost is thus at a maximum. A last in first out (L.I.F.O.) convention is unlikely to reflect actual experience, though allowing it might operate to offer some relief from the unreality of gains arising in conditions of inflation. The items on hand at year end are treated as the earliest acquired. The deferral of cost is thus at a minimum.

Cost where an item was already owned before it became trading stock

14.38 Attention was given in [12.78]ff. above to the question whether an item held by the taxpayer as a capital asset, or held privately, may become trading stock. Some observations in *St Hubert's Island Pty Ltd* (1978) 138 C.L.R. 210 may suggest that it cannot. It would follow that it may only become the subject of specific profit accounting. In which event, it was suggested in [12.78] above, the market value of the item at the time it becomes a revenue asset is its cost for purposes of the determination of a profit or loss on realisation. If it is admitted that the item may become trading stock, the value at the time it became trading stock will be the cost of the item for purposes of the operation of the trading stock provisions.

Cost where an item comes into existence on severance

14.39 The item may be severed from an item that is a capital or private asset, or it may be severed from an item that is a revenue asset which may be an item of trading stock.  

14.40 The latter situation admits of a straightforward analysis. Difficulty however is created by the decision of the High Court in *Webster* (1926) 39 C.L.R. 130. The straightforward analysis would say that shorn wool should have as a cost some part of the cost of the sheep in wool that have been purchased and later shorn. To the extent that a cost is then attributed to the wool, it will diminish the cost of the sheep. Where the sheep are natural
increase, some part of the cost price of natural increase adopted by the taxpayer should in theory be attributed to the wool, though the amount so attributed would be minimal. The trading stock provisions may not be flexible enough to accept this analysis: the notion that the cost of the sheep changes at the time of shearing is not easily comprehended by those provisions. If the analysis is not accepted, the wool will have no cost.

14.41 In *Webster* the majority (Knox C.J., Rich and Higgins JJ.) rejected the straightforward analysis, at least in the application to the facts of the case. The dissenting judges (Gavan Duffy and Starke JJ.) adopted it. It seems that the partnership of which the taxpayer was a member had in its own accounts distributed the cost of the sheep between the sheep and the wool. They had accounted for the sheep for tax purposes on the basis that their cost was the amount distributed to them, and for the wool on the basis that the cost of the wool was the amount distributed to the wool. The Commissioner accepted the accounting in regard to the sheep and no issue was raised in that respect. He refused to accept the accounting in regard to the wool, asserting that the wool had no cost. The issue in the case was the correctness of the assertion that the wool had no cost. The decision in the case is adequately explained as a conclusion that the trading stock provisions at the time of the decision did not have sufficient flexibility to accept the straightforward analysis. It was just unfortunate for the partnership that it had claimed in its tax account, as the cost of the sheep, the amount distributed to the sheep, and not the full amount paid for the sheep—an amount which in turn had been determined by an allocation within a total price paid for the farm with the sheep in wool.

14.42 The reason for the decision given by the majority is, however, that the price paid for sheep in a purchase of a farm and sheep in a walk-in walk-out purchase is a capital outgoing. It is the price of capital assets. Perhaps this view is the explanation of the drafting of s. 51(2) of the Assessment Act in providing that expenditure in acquiring trading stock shall be deemed not to be an outgoing of capital or of a capital nature. The function of s. 51(2) is otherwise explained in [5.23]–[5.26] above. The reason given by the majority emphasises that the price was paid as part of the price of buying the farm. With that emphasis, it reflects a principle which is a corollary of a principle that a receipt on the sale of sheep in a walk-in walk-out sale of a farm is not an income receipt. The latter principle is displaced by the provisions of s. 36 of the present Assessment Act. The majority view has unacceptable implications. If the buyer of a farm acquires the sheep in a distinct purchase, albeit from the seller of the farm, the sheep will be revenue assets and trading stock. It is the purchase of the sheep with the farm that requires them to be treated as capital assets.
and not trading stock. The view of this Volume would be that assets purchased in the purchase of a business may be revenue assets to be accounted for under general specific profit accounting, or revenue assets that are trading stock to be accounted for under the trading stock provisions if they qualify in other respects as trading stock. Section 36 deems the purchaser of a business who acquires in a purchase assets that were trading stock of the seller to have purchased the assets at their market value. In this deeming the section assumes that the stock so acquired may be trading stock of the purchaser.

14.43 The matter of cost when an asset comes into existence on severance from a capital or private asset of the taxpayer, and is thereafter held and disposed of in the carrying on of a business, has been the subject of consideration in a number of earlier paragraphs. A taxpayer may own land and hold it as a capital asset of a farming business, or he may hold it privately. In the land there is a valuable deposit of gravel. The view has been taken in this Volume that, as a matter of general principle, if the taxpayer takes the gravel from the land and sells it in the course of a business he is entitled to a cost of the gravel taken that will include its value as part of the land—in effect what another would have paid the taxpayer for the right to take the gravel from the land. This element of cost is the value at the time of taking. Where the asset taken becomes trading stock on the taking, there will be an allowable deduction of the value of the asset taken. This value will be part of the cost of closing stock if the asset remains on hand at year end.

14.44 There may be reason to distinguish, as a matter of general principle, the case of gravel from the case of timber or other resource that is produced by land. If a taxpayer takes timber from land held as a capital asset of a business of producing and selling timber, and sells the timber, it is arguable that the cost of the timber should include, not its value at the time of taking, but its value at the time the land became committed to the business of producing and selling timber. If the land was acquired to be used in this way, the cost would be that part of the price paid for the land that was attributable to the timber standing on the land at the time of purchase. There is an express provision in s. 124J in regard to timber. The significance of that provision is considered in [12.82] above. Where the produce of the land is one of those referred to in s. 36—standing or growing crops, crop-stools, or trees which have been planted and tended for the purpose of sale—that section will have some significance. In this context, as in regard to trading stock, the section deems the purchaser to have acquired the crop or trees at their value at the time of acquisition. The deeming indicates an assumption that a purchaser who is in business
producing and selling crops or trees will have, on severance, trading stock with a cost that will include the value at the time of acquisition of the land. Clearly, a taxpayer who acquires land in which seed has been sown does not acquire a distinct asset consisting of some part of the crop that will ultimately be harvested and sold. On the other hand, a taxpayer who acquires land with plants in ripe fruit acquires a distinct asset consisting of the crop that will be harvested and sold. There are many intermediate situations. A line must be drawn, and it should be drawn in terms of the state of maturity of the crop: is it commercially identifiable in its condition at the time of acquisition? The view taken in the United Kingdom decision in *Saunders v. Pilcher* [1949] 2 All E.R. 1097 is that there can be an acquisition of a crop that will be a revenue asset of the taxpayer who acquires only if the crop is acquired in a transaction which is separable from the transaction by which the land is acquired—though presumably both transactions may be in the same contract. The separateness of a transaction presumably involves something more than an allocation of price to the crop. A line drawn in terms of legal forms seems hardly appropriate. Jenkins L.J. (at 1106) supports such a line by pointing to the situation of the seller, and making the assumption that the seller will derive income on the sale of the land only if the crop is sold in a separate transaction. Symmetry in the treatment of seller and buyer is not a principle of income tax law, though it may be a desirable policy objective. But there is no authority that would support the assumption made by Jenkins L.J., and a view that the seller may derive income if he sells land with a crop that is identifiable is equally open.

Section 36(1), in its reference to crops, crop-stools and trees planted and tended for the purposes of sale, has an operation to bring about a derivation of income by a taxpayer who disposes of crops, crop-stools or trees, whether or not there is a transaction in this regard separable from another by which there is a disposition of the land. It will thus be important to know the meaning of the word “crop-stool”, a matter considered by Kitto J. in *Amy Strongman Butcher* (1950) 9 A.T.D. 177. And it is possible that, moved by a sense of symmetry, a conclusion will be reached that an assumption of s. 36(1)—that the person acquiring is entitled to a cost—has been made law in regard to items with which s. 36(1) is concerned. It would follow that where there is an acquisition by a taxpayer of land carrying a crop that is identifiable the taxpayer will be entitled to a cost if he is in a business of selling the crop. The conclusion of Kitto J. was that the item in question in *Amy Strongman Butcher* was not a crop-stool so that the section could have no application. He did however contemplate that the assumption of s. 36(1) is made law in regard to the items with which the
section is concerned. He said (at 178):

“The section does not go on to provide that the person acquiring the property shall be entitled to treat the value of it as an allowable deduction, and it was contended by counsel for the respondent that that result does not follow from the section or any other provision of the Act. If this contention is correct, it is difficult to see any purpose in enacting that the purchaser shall be deemed to have purchased the property at its value, and I should have thought that there would be much to be said against the contention. Indeed, I understand the Deputy Commissioner to have acted under s. 36 in allowing the £550 allocated to the purchase of hanging fruit. It is not necessary, however, to express a final opinion on the point, because of the conclusion to which I have come upon the preliminary question whether banana plants fall within the descriptions of property contained in s. 36.”

14.47 On the question whether there is a cost of a revenue asset in other circumstances, he said:

“In my opinion the appellants cannot succeed unless the case falls within s. 36. In so far as s. 51 alone is relied upon, the answer to the claim for the deduction of the sums allocated to the purchase of banana plants is, I think, that, as those plants were growing on the land purchased and therefore formed part of a capital asset acquired, any portion of the total purchase price which may be regarded as attributable to the plants was an outgoing of capital or of a capital nature: cf. Webster v. Deputy Federal Commissioner of Taxation for Western Australia.”

Webster (1926) 39 C.L.R. 130 is the subject of comment in [14.41]–[14.42] above. It does not dictate any general conclusion. In any case, in the particular facts of Butcher, there could not be said to be the acquisition of a revenue asset. The bananas that would eventually emerge from the plants had not yet emerged. They were not yet commercially identifiable. Kitto J. may be taken to have rejected a general principle that would, in the context of the trading stock provisions, allow a deduction of the cost of the growing crop. He would, presumably, explain s. 36(1) as expressing a policy that where a gain that results from the growth of a crop has been brought in as assessable income of a seller on realisation of the land, the value of that growth should be excluded in determining any gain by the buyer that is income on a realisation by him. The implication of that policy would be that where any gain by the seller has not been brought to account as assessable income, the value of the growth should be taxed to the buyer, at least when he sells the resulting crop. The assumption is that where s. 36 (1) does not operate, the seller, on realisation of the land, will not derive a profit that is income. That assumption will not always be correct—the land may be a revenue asset of the seller. In any case, it is not easy to see why the tax consequences for the seller should determine the tax consequences for the buyer. If they do, some rethinking of principle will be necessary if
capital gains come to be generally subject to tax. Kitto J. might perhaps have sought a justification by reference to the law that will treat, as an income gain, a gain derived from property, more especially interest or a dividend that would be said to have “accrued” in part prior to the acquisition of the debt or share by the taxpayer who derives the interest or dividend. The interest or dividend is treated as a gain, as to the whole of its amount, realised by the taxpayer who has acquired the debt or share. It would be said that allowing the taxpayer to exclude the cost of the crop in determining income arising from the taking and sale of the crop, would demand that a taxpayer who acquires a debt or a share should be entitled to a deduction, when he derives interest or a dividend, of so much of the cost of the debt or share as is attributable to the impending payment of the interest or divended. The logic of the argument is sound, but there are problems of attribution, at least in the case of the impending dividend, that would always restrain the recognition of the logic in the development of the law. In any event, there is no justification for treating the failure to allow a deduction in the debt or share situation as reason for denying a deduction in the case of land with a growing crop, or, for that matter, in the case of sheep in wool. The fact that there are some departures from the principle that an item is not income unless it is a gain, does not require an abandonment of that principle.

Cost where more than a normal supply of stock is acquired

14.48 One basis of the decision in Guinea Airways (1950) 83 C.L.R. 584 was that the stock of spare parts held by the taxpayer exceeded a normal supply, and the spare parts were therefore capital assets. A deprivation of them did not in the result give rise to a deductible loss. One implication of that basis of decision would be that there would be a deduction of the value—not the cost—of a spare part taken from the supply and used in a repair of one of the taxpayer's aircraft.

14.49 The question now raised is whether items in a more than normal supply of assets—a stock pile—that would otherwise be trading stock are not trading stock but capital assets. The notion of “normal supply” is, of course, indeterminate. It might have been said in Guinea Airways that, having regard to the remoteness of the taxpayer's operations from a source of supply of spare parts, a substantial supply might none the less have been normal. A normal supply of spare parts is one that gives reasonable assurance that there will be spare parts available when they are needed. And a normal supply of trading stock would be one that gives reasonable assurance that the taxpayer will have stock to sell to meet a demand that
should be anticipated. A supply would be abnormal where it has been built up in the course of a plan to dominate the market.

14.50 There is no case in which status as trading stock has been denied on the ground that the supply held is abnormal. If status as trading stock were denied on this ground, the taxpayer who holds an abnormal supply would run the risk that a loss on deprivation would not be an allowable deduction. An item sold from the stock pile in the ordinary course of business would however become trading stock in the act of disposition. Its cost for purposes of the trading stock provisions would, presumably, be its value at the time of that sale. The result is that there will, very likely, be no profit brought to tax. Which may be thought so incongruous as to demand a reconsideration of any principle that stockpiling will attract the character of capital assets to what would otherwise be revenue assets and trading stock. An alternative analysis would be that the items of stock as they enter the process of sale have no cost, though the proceeds are income. That alternative may be thought to follow from some of the reasoning in Webster (1926) 39 C.L.R. 130, considered in [14.41] above. The result will be that tax is imposed on what is obviously not a gain. Which is also incongruous, and will equally demand reconsideration of any principle that stock-piled assets must be capital assets.

Cost in a two stage acquisition

14.51 It is accepted that raw materials and partly fashioned goods of a manufacturer are trading stock. There is in this a rejection of the view taken by Stephen J. (dissenting) in St Hubert's Island Pty Ltd (1978) 138 C.L.R. 210 a 221, adopting the view of Mahoney J. at first instance, that an item is not trading stock until it is in the form in which it is intended that it be sold.

14.52 The transition from partly fashioned to fully fashioned goods does not amount to a realisation of the former. The partly fashioned goods in effect remain on hand at year end as part of the fully fashioned goods, and the cost of the latter will include the costs of the former. The same analysis was adopted in [14.50] above in relation to the exercise of rights or options that are trading stock. The rights or options in effect remain on hand as incorporated in the shares that are acquired by their exercise, and any costs of the rights or options are costs of the shares.

Cost where there is an element of gift by the person from whom trading stock is required

14.53 The view was taken in [12.84]–[12.85] above that the amount paid
for goods is not their cost where there is an evident pure gift by the seller in the transaction in which the goods were acquired. The cost is the value of the item at the time it is acquired. A receipt that is a pure gift is not within the base of the income tax. It would be caught up in the base if no cost is allowed reflecting the value of the gift.

14.54 In some circumstances a gift received will be income of the taxpayer. The matter is examined in [2.132]ff. above. Thus a trader may receive a non-commercial discount from a supplier in recognition of a gratuitous service that the trader has performed for the supplier. In such circumstances there is a distinct reason why the element of gift in the allowing of the discount should be treated as a cost of the goods. If the element of gift is not treated as a cost, what is in substance the same gain will be taxed twice—once as a reward for service and the second time as a profit on the realisation of trading stock.

14.55 In the last paragraph a distinction is drawn between a commercial and a non-commercial discount. That distinction will not always be easily drawn. *Jacgilden v. Castle* [1969] 3 W.L.R. 839, referred to in [12.86] above, asserts an important principle: even though there is a discount in the sense of a lower price charged for goods than what might be thought to be the prevailing market price, the price charged will none the less be the cost if the discount was allowed in an “honest bargain” between the parties. If it were not so, the law would fail to tax a profit that might be thought to arise from good buying by a taxpayer.

14.56 It was suggested in [12.87] above that a price that reflects an element of gift by the buyer to the seller should not be treated as proceeds of sale by the seller. The realisation should be taken to have been made at market value. The surplus over market value in the amount received may be income otherwise than as a profit on the sale of trading stock, for example as a reward for services. The amount paid by the buyer will be a cost of the trading stock only to the extent of the market value. He may have a deduction for the surplus in appropriate circumstances, for example as a payment for services used in business operations. Again the principle in *Jacgilden* that a price paid in an “honest bargain” should stand, is applicable. The finding of an element of gift should not easily be reached.

**Cost where the amount paid for trading stock is excessive**

14.57 The immediately preceding paragraphs adopt a principle that a price paid for trading stock in an “honest bargain” should stand as the cost of the stock. That principle bears no affinity with an approach to the interpretation and operation of s. 51(1) which is described in [9.17]ff.
above as “form and blinkers”. Indeed, it reflects a rejection of that approach. There is no honest bargain, though there is a contract under which the trading stock is acquired, if the price paid significantly exceeds the market price and the parties are not at arm's length. *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430 may be an illustration, though the excessiveness of the price in that case was modest. Excessiveness and the relationship between the parties justify the finding of an element of gift—in the circumstances of *Cecil* a gift made in the course of profit-shifting between taxpayers.

**14.58** The “honest bargain” principle applied in the interpretation and operation of s. 51(1) will allow the denial as a cost of some part of the price of trading stock. To an extent it makes the express provisions in ss 31C, 65 and 82KJ and 82KL and Div. 13 of Pt III unnecessary. Those provisions are explained in [10.289]–[10.362] above. Section 31C, however, may direct the denial of a cost where it would otherwise be allowed. It may deny part of a cost, notwithstanding that there might be said to be an honest bargain, where the Commissioner is satisfied that the purchaser of an item of trading stock could have purchased an identical article from another person for a price less than that cost. It will have this effect if the Commissioner is satisfied that the parties were not dealing with each other at arm's length in relation to the transaction. And it will have this effect even though the Commissioner is unable to reach a state of satisfaction that the price charged was not an “arm's length price”. Section 31C may operate to deny a cost when s. 51(1), even on the interpretation and operation of that provision asserted in this Volume, would not. Thus s. 51(1) may not deny a cost in the circumstances of *Cecil*, but s. 31C will admit of such a denial. An arm's length price that a taxpayer might pay for trading stock will presumably increase, the lower the level of distribution at which the stock is acquired. The family company supplying the taxpayer company in *Cecil* was supplying at a lower level of distribution than the wholesalers with whom the taxpayer had formerly dealt. It is thus arguable that the price charged by the family company was a price that the family company might have charged had it been dealing at arm's length with the taxpayer.

**Accounting on the Realisation of Trading Stock**

**14.59** Section 51(2) overcomes what was thought to be a difficulty about the deductibility under s. 51(1) of the cost of trading stock. The effect of s. 51(2) is examined in [14.1] above. But s. 51(2) leaves the matter of what is to be treated as an outgoing to the operation of general principles of tax
accounting. To the extent that an outgoing for trading stock might be accounted for on a cash basis, it is arguable that there is no “cost” to be deferred by the operation of s. 28 until the stock have been paid for. It would be a rogue operation of the trading stock provisions that a taxpayer electing cost might be required to bring in an amount as income in respect of stock on hand at year end, when he is not yet entitled to deduct the outgoing in respect of the stock because he has not yet paid for the stock. Similarly it would be argued that there is no “cost” to the extent that an accruals basis taxpayer is not yet entitled to deduct an outgoing. A provision for long service leave in respect of employees employed in the taxpayer's manufacturing operation should not be treated as a cost of manufactured goods.

14.60 The deferral of the deduction of cost that results from s. 28 ceases when an item of trading stock ceases to be “on hand”. There is, however, no statutory provision identifying the moment when there will be a derivation of income that is the proceeds, or the deemed proceeds of realisation of trading stock. The conclusion of the High Court in J. Rowe & Sons Pty Ltd (1971) 124 C.L.R. 421 that the actual proceeds of sale of trading stock, where accruals applies, should be accounted for when they become receivable even though they are not presently receivable, was in part moved by the view that there should be an item of income to match the outgoing for cost that, in effect, becomes deductible when the trading stock ceases to be “on hand”. But the operation of accruals accounting in this way will not necessarily produce that result. A taxpayer on accruals who produces trading stock that are acquired by a marketing authority, may not yet have proceeds of realisation because the amount that he is entitled to receive has yet to be ascertained. Farnsworth (1949) 78 C.L.R. 504 affords an illustration. The trading stock provisions in these circumstances have a rogue operation.

14.61 Where a taxpayer disposes of trading stock otherwise than in the ordinary course of carrying on his business, there will be a derivation of income in the amount of the value of the stock (s. 36). Value, as defined in s. 36(8), is “the market value of the [trading stock] on the day of the disposal; or if, in the opinion of the Commissioner, there is insufficient evidence of the market value on that day—the value which in his opinion is fair and reasonable”. A valid opinion must, presumably, be directed to an estimate of market value. In this situation, it is irrelevant how much the taxpayer may have received or be entitled to receive. And it is irrelevant that an amount he is entitled to receive has not yet been ascertained. If the words “on hand” in s. 28 and the word “disposes” in s. 36(1) are construed so that an item necessarily ceases to be on hand when it is disposed of, the
possibility that there may, in effect, be a deduction of cost before there are matching proceeds is overcome.

14.62 Generally, an accruals basis taxpayer will derive income, in the form of a receivable, when he has realised an item of trading stock. An item is not realised until property has passed and the passing of property will generally be a condition precedent to a claim to receive proceeds. A reference to passing of property attracts the law's distinction between a passing of property in equity and a passing of property in law. Where an equitable title passes in land—the contract of sale being specifically enforceable—there will presumably be a realisation. If the contract does not in fact proceed to completion, so that legal title does not pass, the analysis of the transaction becomes complex. If the buyer makes some payment to the seller to obtain a release from his obligation to complete, the receipt by that seller will be his income as compensation for a profit he would have made had the contract been completed. The seller has also derived income of any amount received under the contract that he is entitled to retain. And he is now entitled to a deduction of the cost of the property he has again acquired. A satisfactory analysis would assert that the seller has incurred an outgoing in the reacquisition of the equitable title, and that outgoing is thereafter his cost in respect of the property. The outgoing is the value of his right to the proceeds of sale: s. 21 is attracted. The final outcome, apart from the possible derivation of a compensation receipt and a deposit retained that are income, is that the seller's cost of the land has been written up by the amount of the difference between the original cost and the proceeds to which he was entitled under the sale that did not proceed to completion, and there is, to this extent, a derivation of income by him. Or, if the proceeds are less than cost, there will have been a write-down of the original cost, and to this extent the seller has an allowable deduction. An alternative analysis would treat the agreement to rescind the contract as a giving up of the claim to the proceeds of sale, which will give rise to an allowable deduction of the amount of the claim. The land will be treated as still on hand at its original cost. The taxpayer will have income in the amount of the proceeds of sale, any compensation for profit lost and the amount of any deposit received he is entitled to retain. The alternative analysis will, of course, be generally the more attractive to the taxpayer.

14.63 Section 36 may be said to treat a disposal, in the circumstances to which it applies, as a deemed realisation for an amount equal to the value of the property. That amount is forthwith income derived, whatever may be the taxpayer's basis of accounting in relation to the item. The question was raised in [12.89] and [12.99]ff. whether a general principle of tax
accounting might not apply to bring about a deemed realisation, with the like consequences, in other circumstances.

**14.64** A taxpayer may take an item out of trading stock and use it as a capital asset of his business when it will become subject to the depreciation provisions—a taxpayer dealing in motor cars may take an item of stock and use it as a “demonstrator” vehicle, or use it for the conveyance of staff and clients. The most rational analysis would treat the change of use as a realisation at market value. The cost of the item for depreciation purposes would be that market value. The consequences on ultimate actual disposal would be those applicable under the depreciation provisions. Trading stock accounting would at that time have no application. Attention was given in [12.104] above to the difficulty, in adopting this analysis, which is posed by s. 36 as it has been interpreted in *Murphy* (1961) 106 C.L.R. 146. That section, as so interpreted, may displace any general principle. The taking of an item out of trading stock of a business, and the use of it for private purposes, were the essential facts in the United Kingdom decision in *Sharkey v. Wernher* [1956] A.C. 58 where a general principle of deemed realisation on change of use was recognised. If any general principle is displaced, the item of trading stock will remain on hand as an item of trading stock despite the change of use. The cost of the item will, in effect, be deductible at the time of actual disposal. That disposal will presumably be a disposal otherwise than in the ordinary course of business so that s. 36 will then apply. Such an operation of the trading stock provisions may be acceptable, though analytically unsatisfactory, provided the depreciation provisions are simply ignored. But a like operation of the trading stock provisions will be unacceptable if an item of trading stock is taken from stock and used by the taxpayer for private purposes. There will of course be no room for the depreciation provisions, but treating the item of stock as still on hand until disposal, and the operation of the trading stock provisions on disposal, will in effect allow the taxpayer a deduction for the depreciation of an item of property used for private purposes.

**14.65** A principle that there is a deemed realisation on change of use would extend to the taking of an item out of the trading stock of one business and its inclusion in the trading stock of another business of the same taxpayer. There will be questions as to whether the second business is a distinct business, or a division of the old. If it is a distinct business the operation of the principle will give a more rational system of tax accounting. It would, however, bring about a derivation of profit on the deemed disposal, and might be seen as an unacceptable anticipation of income. Section 36 would presumably not be applicable on the eventual realisation of the item in the ordinary course of carrying on the second business, though it is arguable
that the disposal is not in the ordinary course of carrying on “that business”—the phrase used in s. 36(1)(c). The reference in that phrase is to the first business. Disposal in the second business could not be in the ordinary course of carrying on the first.

14.66 Taking for private purposes would extend to the killing of an item of livestock for rations, at least where those consuming the rations are the taxpayer and his family. The instructions for filing returns issued by the Commissioner direct that in these circumstances income equal to the cost of the item of livestock should be taken to be derived. The assumption is that s. 36 is not applicable—the item of livestock has not been disposed of. The direction does not appear to be justified by any other specific provision, or any general principle. The direction, if followed, will achieve some correction of what would otherwise, in effect, be the allowance of a deduction in respect of expenses of producing or acquiring food consumed by the taxpayer. It is of course only a partial correction. The correction is minimal where the item is natural increase and the scheduled cost price of natural increase is applicable.

14.67 Where s. 36 operates the taxpayer acquiring the property is deemed to have purchased it at a price equal to its value. This deeming will, presumably, displace any actual consideration given by the taxpayer acquiring the property. Where there is an element of gift in the disposal of the trading stock to the person who acquires it, the deeming will protect that gift from being taxed in the hands of the person acquiring it. That gift might otherwise be taxed as a part of any profit that is income when the taxpayer who has acquired realises the item. If the acquisition of the property is a derivation of income by the taxpayer who acquires it, the deeming will protect the taxpayer against being taxed twice on the amount. There may be a derivation of income to the extent that the value of property exceeds the consideration given where the opportunity to acquire the property at less than the value of the item is, for example, received by way of a reward for services performed by the taxpayer who acquires it.

14.68 In *St Hubert's Island Pty Ltd* (1978) 138 C.L.R. 210 a distribution of land in specie made to a holding company in the liquidation of the taxpayer company, was held to be a disposal of the land to which s. 36 applied. The case was not concerned with the tax consequences for the holding company. Those consequences raise a question of the operation of s. 36 in deeming the person who has acquired the property the subject of the disposal to have “purchased it at a price equal to its value”. The deeming may preclude the operation of s. 47 in relation to the distribution in specie. Section 47 would deem the distribution, to the extent to which it presents income derived by the company making the distribution, to be dividends
paid to its shareholders by that company out of profits derived by it. On the facts of *St Hubert's Island* there may be some analytical difficulty in saying that the land distributed to the holding company in part represented the income that was derived, by force of s. 36, in the very act of making the distribution. In other circumstances, however, property distributed in specie may clearly represent income derived on an earlier occasion by the company making the distribution, in whatever way one answers the question whether it represents income arising from the operation of s. 36 in the act of distribution. There is then a competition of deemings. Presumably the land could not be said to be both a dividend and an item purchased at its value by the shareholder receiving the distribution. The resolution of the competition might adopt the deeming in s. 47 as the more specific.

14.69 Subsection (9) of s. 36 was added to s. 36 in 1978 to deal with planning to transfer an unrealised loss to another taxpayer or to a partnership of taxpayers. The unrealised loss would be inherent in a situation involving dividend stripping. A taxpayer company might have acquired all the shares in another company and have intended to strip the company of its assets by taking them in a dividend distribution. If it did take the assets in this way, it would receive rebatable dividends: *Investment & Merchant Finance Corp. Ltd* (1971) 125 C.L.R. 249 had established as much. And if it were a share trader and sold the shares after the stripping, it would, in effect, incur a substantial loss by the operation of the trading stock provisions. *Investment & Merchant Finance* had also established that shares acquired in these circumstances were none the less trading stock—a decision criticised in [2.451] above. The taxpayer company, A, might not be able to make effective use of the loss realised in this way, having inadequate income against which it might be set. The planning would then have been to defer both the taking of the dividends and the realisation of the loss. The shares, X, would be sold to another taxpayer (or partnership of taxpayers), B, in business in share trading for an actual price that reflected other aspects of the plan by which the purchaser would be under an obligation to ensure that new shares, Y, in the company whose shares had been purchased would be allotted either to the taxpayer company A or to its associated company, and dividends were then paid on those shares so that the company was stripped of its profits. Subsequent to the stripping, the shares acquired by the taxpayer (or partnership of taxpayers), B, would be sold and this sale, it was argued, generated a substantial loss. It was said that the sale by taxpayer company A to taxpayer B or partnership of taxpayers B was not in the ordinary course of business by A, so that there was a deemed sale under s. 36 at market value, and not at the much lower
price in the actual sale. Taxpayer (or partnership of taxpayers) B was in the result deemed by s. 36 to have acquired at that value, so that there was a tax loss experienced on the on-sale after stripping.

14.70 Planning of this kind has been affected by new ss 46A and 46B which may result in a denial of the dividend rebate otherwise afforded by s. 46. Section 46A dates from 1972 and has been the subject of a number of amendments. Section 46B dates from 1978. Planning of this kind has also been affected by s. 36(9) which gives the Commissioner a discretion, in circumstances which include those described, to treat the sale otherwise than in the ordinary course of business as a sale not at market value but at such value as the Commissioner considers reasonable. The Commissioner may set a value on the sale by taxpayer company A that will ensure that the loss is suffered by that taxpayer at the time of that sale, and not by taxpayer B, or partnership of taxpayers B, on the on-sale.

14.71 It may be doubted whether s. 36(9) was necessary. There is an assumption that what is sold by taxpayer company A in the plan described above is all the rights that make up the shares. It is at least arguable that the agreement between buyer and seller limits the rights that are the subject of the sale. It is the market value of these limited rights that must be determined under subss (1) and (8) of s. 36.

14.72 Section 36A overcomes the decision in Rose (1951) 84 C.L.R. 118, and extends the operation of s. 36 to circumstances where a change has occurred in the ownership of, or in the interests of persons in trading stock, but the change does not involve a disposal by the person or persons who owned or possessed interests before the change. The typical, perhaps the only circumstances to which the section can apply, will be those specifically identified in the section—the formation or dissolution of a partnership, or a variation in the constitution of a partnership, or in the interests of the partners. Section 36A provides that s. 36 will apply “as if the person or persons who owned the property before the change, had, on the day on which the change occurred, disposed of the whole of the property to the person, or all the persons, by whom the property is owned after the change”.

14.73 Section 36A(2) gives an election that will allow the parties to a change in interests within s. 36A(1) to escape, to a degree, the operation of s. 36. The election requires a 25 per cent continuity of interest, and the participation of all the persons who owned before and of all the persons who own after the change in interests.

14.74 The effect of the election by the parties to a change is to substitute for the market value that would otherwise be the value on the deemed disposition, “the value (if any) that would have been take into account at
the end of the year of income if no disposal had taken place and the year of income had ended on the date of the change”. Thus the election might ensure that the trading stock was the subject of a deemed disposal at cost. There is, however, a problem of identification raised by s. 36A(2) in the reference to “the value . . . that would have been taken into account at the end of the year of income if no disposal had taken place”. That value could have been determined by the exercise of an option under s. 31 or s. 33. It may be that a specification of a value in the election will serve as an exercise of an option for purposes of determining the value that would have been taken into account.

14.75 Section 36A(2) gives rise to other problems of interpretation. Thus it might be thought to be inapplicable to the withdrawal of a partner, since not all those who owned before the change will be represented among those who own after the change. In fact the section has not been interpreted in this way.

14.76 Since 1977 the election is only available where the market value is greater than the value that would be applicable if the election were effective. The significance of this restriction appears in [14.80] below. The election given by s. 36A(2) is only available where, upon the change in interests, the property becomes an asset of a business carried on by the person or persons by whom the property is owned after the change. A change in interests that will bring s. 36A(2) into operation includes the death of a partner, and s. 36A(4) specifies the parties that must participate in the election. The place of the deceased partner is taken by the “trustee of his estate and the beneficiaries (if any) who are liable to be assessed in respect of the whole or a share in the income of the business of which the property becomes an asset”. Where death brings about a dissolution of partnership, the condition that those who own the property after the change in interests must carry on business will not be satisfied, though the surviving partner may carry on business using the deceased partners share in the assets. No election will therefore be possible (Elder's Trustee & Executor Co. Ltd (Satchell's case) (1961) 104 C.L.R. 12).

14.77 Where the death of a partner does not bring about a dissolution of partnership, an election is available. The death of a partner will not bring about a dissolution of the partnership if the partnership agreement provides that the partnership business will be continued by the surviving partners for their benefit and the benefit of the estate of the deceased. An election is necessary to prevent the operation of s. 36A—which will, in effect, bring about a write-up of the trading stock to market value—notwithstanding that the death of the partner is not an occasion for the taking of a partnership account, and there will be no operation of ss 90 and 92 to bring about
derivation of income by the surviving partners and by the deceased partner. 14.78 Prior to 1977, planning of the kind described in [14.69] above had involved the use of the election given by s. 36A(2). Such planning was held effective in Westraders Pty Ltd (1980) 144 C.L.R. 55. Taxpayer company A would have taken dividends on the shares, X, before the sale to a partnership of taxpayers B. Taxpayer company A would have a 25 percent interest in the partnership of taxpayers B. An election would require the operation of s. 36, in such a way that the shares X would be taken to have been disposed of at cost. The partnership of taxpayers B would pay only marginally more than the market value for the shares, but would be deemed to have acquired them at their cost to taxpayer company A. That cost, paid by taxpayer company A before the dividend stripping, would be a much higher figure than the value of the shares at the time of the disposition to partnership of taxpayers B. On the on-sale by partnership of taxpayers B, the trading stock provisions would, in effect, give rise to a substantial loss, which would, under the partnership provisions, more particularly s. 92(2), be distributed among the partners including taxpayer company A. In the outcome, taxpayer company A as a partner in the partnership would have realised a part of the potential loss on the shares that had been the subject of the dividend strip, and gained by the price in fact charged the partnership of taxpayers B, which would reflect to a degree the value of the remainder of the potential loss.

14.79 Planning of this kind associated with dividend stripping has now been made impossible by s. 36A(5), inserted in 1977, and s. 36A(6) inserted in 1979. By those provisions the privilege of election is denied when the change in ownership or interests relates to a chose in action. The planning described in the last paragraph would, after 1977, have been defeated in any event by the addition in that year of one of the general conditions of the availability of an election now specified in s. 36A(2)(c). The market value of the property must be greater than the value that would be applicable if the election were effective.

14.80 Where planning relates to property other than choses in action, an attempt to transfer a loss, if not defeated by the conditions of availability of an election under s. 36A(2), is now defeated by s. 36A(7), inserted in 1979. An election is not available when the value of the property as determined by the Commissioner under s. 36(9) is less than or equal to the value of the property that would be applicable if the election were effective. In determining the value under s. 36(9) the Commissioner is entitled to have regard to an amount specified as the value of the property, or as the consideration receivable in respect of the disposal in any agreement entered into in connection with the disposal of the property.
14.81 The s. 36A(2) election is not available where there is an outright disposition of trading stock from one taxpayer to another. At least one, perhaps all, of the persons who own before the change must have a continuing interest after the change. It was however suggested prior to the addition of subss (8) to (10) of s. 36A in 1981 that appropriate planning might achieve an outright disposition by way of two transfers, each of which involves a continuing interest. Thus A might take another taxpayer, to whom he proposed to transfer his business, into partnership with him, and the partners might make an election under s. 36A(2) so that the stock was disposed of and acquired at cost. He might then dispose of his continuing interest to the other taxpayer, and the parties might make another election to the same effect. The second election raised a problem of interpretation of s. 36A(2) to which reference was made in [14.74] above, and it might always have been ineffective to preclude the operation of ss 36A and 36. In any event, subss (8), (9) and (10) of s. 36A have qualified the effectiveness of the planning. Subsection (8) precludes an effective election where a change in interests has occurred, otherwise than in the course of ordinary family or commercial dealing, and the amount of the consideration received or receivable in respect of the change in interests by the person or persons who owned before the change, or any one of them, substantially exceeds the consideration that might reasonably be expected to have been received or receivable if the value of the property before the change had been the value that would have been applicable if the election had been effective.

14.82 Two transfers that are parts of a single plan are unlikely to be held in the course of ordinary family or commercial dealing, and the effectiveness of the elections will depend on the amount of the consideration received or receivable. Where the plan involves an outright transfer at arm's length, the amount of the consideration receivable is likely to defeat the elections, where the market value of the trading stock is substantially higher than the value that would be applicable if each election were effective. Where the planning involves a transfer of ownership, for example, to a family company in which the transferor has no interest, the consideration received or receivable could be such as would allow the effectiveness of the elections. Where the transfer is to a company in which the transferor has a substantial interest, the consideration receivable will include the increase in the value of his interest in the company, and is likely to involve a defeat of the elections. Curiously the latter situation might be thought to be one where a tax deferral brought about by elections is more acceptable.

**Accounting for Trading Stock on Death**
Section 37 applies a regime in respect of trading stock held at the date of a taxpayer's death, which is similar to the regime applied by s. 36 to trading stock that is the subject of a disposal otherwise than in the course of carrying on the taxpayer's business. But there is a number of differences which may be more than verbal.

Section 37(1) provides that “where the assets of a business carried on by a taxpayer devolve by reason of his death, and those assets include any property being trading stock, standing or growing crops, crop-stools, or trees which have been planted and tended for the purpose of sale, the value of that property shall . . . be included in the assessable income derived by the deceased up to the date of his death, and the person upon whom the property devolves shall be deemed to have purchased it at that value”. It will be noted that the subsection operates when property “devolves”. Presumably the consequence is that trading stock ceases to be “on hand” at the moment of derivation of assessable income of the amount of the value of that stock. Otherwise there would be an item of assessable income and no matching deduction of the cost, or other value chosen by the taxpayer under s. 31 or s. 33.

The subsection refers to the “assets of a business carried on by a taxpayer” and may require that the business is carried on by the taxpayer at the time of his death. Indeed the differences in the comparable provisions of s. 36 may dictate such a conclusion. Section 36 refers to “property” that “constitutes or constituted the whole or part of the assets of a business which is or was carried on by the taxpayer”. It would follow that if a taxpayer has ceased to carry on business at some time before his death, but retains until his death items that had been trading stock of that business, s. 37 will have no operation. There is some prospect that s. 36 will have operated at the time when the business ceased. If it did not, questions as to the tax consequences on death need to be resolved. One might accept that there is no derivation of assessable income on death if there is no deduction of cost or other value effective at that time. There will be a deduction if devolution on death precludes the trading stock being on hand at death. It has already been noted that s. 37 assumes that trading stock ceases to be on hand at death. It would be argued that the assumption is equally valid if s. 37 does not operate to bring on a derivation of income. But the allowing of a deduction of cost or other value when there is no matching item of assessable income gives a rogue operation to the trading stock provisions which is unacceptable. The appropriate outcome might be the recognition of a simple abortion of the transaction in the trading stock, so that there is no profit brought to tax and no loss deductible. That outcome would be rational in most circumstances, though there would be unmatched...
deductions where natural increase of livestock that are trading stock have been brought to account under s. 28 at the nominal amounts prescribed by regulations. The rational outcome requires a conclusion that s. 37 does not operate, and that an item that was trading stock remains on hand at the moment of death.

14.86 When s. 37 operates, “the value” of the property is included in the assessable income derived by the deceased up to the date of his death, and the person upon whom the property devolves is deemed to have purchased it at that value (s. 37(1)). “Value” for this purpose is identified as the amount which, under s. 36, would have been included in respect of that property in the assessable income of the deceased if he had not died but had disposed of the property otherwise than in the ordinary course of his business on the day of his death (s. 37(2)). This value, by the operation of s. 36(8), is the market value of the property on the day of the disposal, or if, in the opinion of the Commissioner, there is insufficient evidence of the market value on that day, the value which in the Commissioner's opinion is fair and reasonable.

14.87 Section 37(2) includes a proviso that “if the trustee of the estate of the deceased and the beneficiaries (if any) who are liable to be assessed in respect of the income of the business, or of a share in that income, unanimously so agree and give notice of their agreement to the Commissioner at the time and in the manner prescribed, that value” (the value for purposes of s. 37(1)) “shall be the value, if any, at which that property would have been taken into account at the date of the death of the deceased person if he had not died, but an assessment had been made in respect of the income derived by him up to that date”. The reference to “value at which the property would have been taken into account” is a reference to value for purpose of s. 28(1). That value, in the case of trading stock other than livestock, depends on the exercise by the taxpayer of the election given to him by s. 32. It is not evident what assumption as to the exercise of that election is required by s. 37(2). In the case of livestock, the value also depends on the exercise by the taxpayer of an election, though in this case a change to a different election is not available except with the leave of the Commissioner (ss 32, 33). To give efficacy to s. 37(2), it seems necessary to imply a power, in the parties to the election, to specify a value that could have been specified by the deceased in making the election, if he had not died.

14.88 The operation of the election given by the proviso to s. 37(2), where the item of property is standing or growing crops, crop-stools, or trees which have been planted and tended for the purpose of sale, is obscure. It may be that an item of property of the kinds mentioned is already trading
stock, though it is not yet severed from the land. However, the drafting of ss 36 and 37 tends to assume that it is not: the listing of items refers to trading stock and then to the other items. If the other items are not trading stock, there will be no value that would have been taken into account at the end of the year of income. Section 37(2) contemplates this situation in the words “if any” appearing in the proviso. The amount to be included in the assessable income derived by the deceased is zero, and the estate will be deemed to have purchased the items at zero cost.

14.89 There is a question whether the election given by s. 37(2) proviso is available if the trustee of the deceased estate does not carry on a business in which the trading stock or other items of property are revenue assets. Where a partner dies and s. 36A is operative, there is an election given by s. 36A(2) and s. 36A(4) which is not available unless the item of property becomes “an asset of a business carried on by the person or persons by whom the property is owned after the change” (s. 36A(2)(a)). In Elder’s Trustee & Executor Co. Ltd (Satchell’s case) (1961) 104 C.L.R. 12 Windeyer J. took the view that no election was available when death brought a partnership to an end. Though there are no words in the s. 37(2) proviso corresponding with the words of s. 36A(2)(a), an inference might be drawn from the reference to “beneficiaries (if any) who are liable to be assessed in respect of the income of the business” that an election is available only when the estate carries on a business of which the items of property are revenue assets. The words used are “the income of the business”, which may suggest some principle of continuity of business which transcends the proprietorship of the assets of the business. Official Receiver in Bankruptcy (Fox’s case) (1956) 96 C.L.R. 370 may be taken to reject any such principle, though it was concerned with the possibility that a profit-making scheme, within the second limb of s. 26(a), now s. 25A(1), might have continuity from the deceased to the deceased estate. A distinct business carried on by the estate, of which the assets are revenue assets should be sufficient to make an election possible. The distinct business must presumably be a continuing business: it is not enough that the trustee embarks on an isolated business venture in relation to the items of property that devolve on him. The distinction between a continuing business and an isolated business venture, considered in [2.431]–[2.434] above is raised. If the judgment of Jacobs J. in St Hubert’s Island Pty Ltd (1978) 138 C.L.R. 210 at 237 is accepted, there cannot be a continuing business unless there has been at least one acquisition of property for the purpose of resale. If a trustee merely carries out development and sale of property that has devolved from a deceased who had purchased the property and carried out some development and sale, the trustee will not carry on a continuing
business. It is true that the operation of s. 37 is that a purchase by the trustee of the estate is deemed to have occurred. But it may be doubted that this deemed purchase would supply an element that will make the activity of the trustee a continuing business so that an election is available.

14.90 Section 37 makes an assumption that assets that devolve on the trustee of a deceased estate and are held by him for sale in the carrying on of a business can be revenue assets of a continuing business carried on by the trustee. That assumption is in some conflict with the judgment of Jacobs J. in *St Hubert's Island*. And it is in conflict with *Webster* (1926) 39 C.L.R. 130 ([14.41] above) and observations in the judgment of Kitto J. in *Amy Strongman Butcher* (1950) 9 A.T.D. 177, quoted in [14.47] above. The view of this Volume is that the assumption of s. 37 is to be preferred.
Chapter 15: Tax Accounting in Conditions of Inflation

Introduction

15.1 Proposition 4 ([2.38]ff. above) describing an aspect of the ordinary usage concept of income assumes that income involves a gain to the taxpayer. Some qualifications on that proposition were noted, the most important arising from the fact that income tax law, save for a brief period covering the 1977, 1978 and 1979 years of income, makes the assumption that the value of money does not change.

15.2 In the determining of the amount of a profit that is income or a loss that is deductible, costs will be expressed as the number of dollars outlaid if the taxpayer is on a cash basis of accounting, or the amount in dollars of a monetary liability at the time the liability arose if he is on an accruals basis. And the proceeds of realisation will be expressed in terms of the number of dollars received or receivable at the time of realisation. There will not be any adjustment of the cost to reflect the circumstance that the dollars of cost were more valuable dollars than the dollars received or receivable at the time a profit was derived or a loss incurred.

15.3 Amortisation of the cost of an asset, whether under the depreciation provisions or other provisions having a like function will be allowed by reference to historical cost—the number of dollars outlaid or deemed outlaid at the time the cost subject to amortisation was incurred—notwithstanding that those dollars were of greater value than the value of the like number of dollars at the time of the allowance of amortisation.

15.4 The amount that is income as a gain derived from a monetary asset—generally interest on money lent—will reflect the number of dollars derived notwithstanding that some of those dollars might be seen as simply a receipt by the taxpayer of an amount that reflects the fall in the value of the monetary asset whence income is derived.

15.5 In the last instance given, there is however some recognition that the value of money does change in the principle discussed in [2.285]ff. above: a discount or premium received in relation to the lending of money may be treated as being for the undertaking “of the capital risk” involved in the lending of money. One justification for treating the discount or premium as being for the capital risk is that it compensates the lender for the fall in the value of his monetary asset: the dollars of his loan returned to him will be of less value than the dollars that he lent, if there has been a fall in the value of money.

15.6 It may be thought that the distortions that flow, in conditions of
inflation, from the assumption of the income tax that dollars have immutable value can be easily cured. Wherever the amount of a cost enters the calculation of a profit that is income or loss that is deductible, its amount should be determined not by reference to its value in dollars at the time the cost was incurred, but by reference to its value in dollars at the time the profit or loss is struck. Whenever the amortisation of a cost is allowed, it should be allowed by reference to the amount of the cost expressed not in dollars of the time the cost was incurred but in dollars of the time the amortisation deduction is allowed. Whenever the amount of income gained from a monetary asset falls to be determined, the gain should be adjusted to take account of the fall in value of the monetary asset reflected in the less value of the dollars that would now be receivable or received in satisfaction of the monetary asset.

15.7 But the distortions are not so easily cured. They may be cured in this way if the taxpayer has not borrowed or otherwise received accommodation from a creditor. If he has received accommodation and used that accommodation to meet a cost that enters the calculation of a profit or loss that is income or deductible, or to meet a cost that is amortisable, or in making an investment in a monetary asset which yields income in the form of a gain derived from property, the gain that may arise on the discharge of the liability that arose from the receipt of accommodation must be brought to account.

15.8 The notion of gain arising from the discharge of a liability is no longer a novel idea in income tax law. It was recognised by the High Court in *International Nickel Australia Ltd* (1977) 137 C.L.R. 347, a case concerned with exchange gains, discussed in [12.192]ff. above. *International Nickel* was a decision that marked the recognition of a new analysis of the nature of income and deductible loss as aspects of the ordinary usage concept of income.

15.9 The recognition of gains and losses that are income or deductible where there are exchange gains and losses, provides an important framework of analysis to support the recognition of gains and losses as a means to correct the distortions that arise in the operation of the income tax in conditions of inflation. But the recognition in the field of exchange gains and losses stops short of the recognition that is necessary if inflation distortions are to be corrected. The law in relation to exchange gains and losses extends only to gain or loss on a receipt in satisfaction of a receivable on revenue account, or on the discharge of a liability on revenue account, arising from a lending or borrowing, or from accommodation otherwise given or received. In one respect that law might have gone further so as to recognise that an exchange gain or loss that is income or
deductible might arise in relation to accommodation given from which interest may be derived and in relation to accommodation received where interest on that accommodation is deductible. Certainly the recognition of an inflation adjustment gain or loss as income or deductible is necessary in relation to any monetary asset whence income from property—interest or receipts in the nature of interest—may be derived, and any monetary liability where the cost of servicing is a deductible outgoing.

15.10 At this point in any development of theory about inflation adjustments, some of the most intractable problems of identification that beset the income tax arise. A good deal of attention was devoted in [6.86] ff. above to the matter of identification of a borrowing that is outlaid for the purpose of producing assessable income, an identification which goes to the deductibility of interest on that borrowing. Such an identification will be necessary if an inflation gain on discharge of the borrowing is to be brought to account. And clearly it must be, if inflation losses arising from the investment of the borrowing, or from the acquisition of revenue assets with the money borrowed, are to be brought to account. The lesser task of identifying a borrowing on revenue account which is an aspect of the law of exchange gains and losses, does not take analysis far enough where the issue is the bringing in of an inflation gain that will balance an inflation loss.

15.11 Against this background it may be helpful to survey the Australian discussion of inflation tax accounting; the recommendations that have emerged; the action that has been attempted and abandoned; and the inadequacies of that action.

Australian Discussion of Inflation Tax Accounting


The Report of the Asprey Committee

15.13 The Asprey Committee in para. 8.183 of its Report left the matter of adjustments for inflation in determining the taxable income of a business to the consideration of the Mathews Committee. It was one of the matters specially committed to the Mathews Committee. The Asprey Committee did however risk an observation that the bringing in of a gain arising from
the discharge of accommodation received, where money has fallen in value, may not be thought appropriate if one's approach concentrates on the need of a business entity to maintain a level of funds sufficient to be able to meet the higher costs in dollar terms of replacing stock and depreciable assets. Such an approach is basic to that kind of financial accounting that is referred to as current cost accounting. On the other hand, if an approach is taken in terms of gains that reflect accretions to the value of the interests of the proprietors of a business, which will include the holders of equity capital in a company, the bringing in of some gains arising from the discharge of accommodation received is essential to ensure that adjustments for inflation are thorough going in removing distortions that affect the equity of the income tax.

15.14 The Asprey Committee also gave consideration to the need to adjust the interest gains that may be derived from monetary assets, so that there is excluded from income that part of any receipt that is in effect a repayment of a lending, because it is no more than equivalent to the fall in value of the dollars of the monetary asset. The Committee proposed an ad hoc arrangement that would allow a deduction, in computing taxable income, of a fixed amount of net interest—interest received less interest that is deductible as interest on money borrowed and outlaid for the purpose of earning income from business or property. The adjustment was intended to correct some of the distortion that arises from inflation, but did not express any developed theory of inflation adjustments.

The Report of the Mathews Committee

15.15 The Mathews Committee was specially charged with the function of making recommendations as to adjustments that should be made in determining the taxable income of a taxpayer conducting a business, so as to remove distortions arising from inflation. The most significant aspect of those recommendations is the absence of any proposal to bring in gains arising from the discharge of accommodation received. The absence of any such proposal reflects the accounting theory that underlies the recommendations made by the Committee. That theory is current cost accounting. An aspect of that theory is the maintenance of the business entity. In conditions of inflation, it is said, a business entity does not gain by discharging accommodation though the payments are, in terms of their value, less than the value of the accommodation received. It does not gain because it will need new accommodation, of a greater amount than the amount of the dollars paid, if it is to maintain the same level of operations as it conducted before the payment. The theory is beyond doubting, but
there is a question of its relevance to an income tax that is concerned with equity between taxpayers. The theory, in its relevance to an income tax, is an argument for abandoning equity by giving special treatment to taxpayers engaged in business in order to preserve business entities.

15.16 The recommendations of the Mathews Committee in regard to adjusting costs to take inflation into account equally reflect current cost accounting theory. Accounting—sometimes called current purchasing power accounting—that is concerned only to adjust costs for inflation by expressing the value of those costs in dollars of the time a profit is to be struck, or at the time a cost is an allowable deduction, will simply apply a general index of purchasing power to those costs. The value of dollars is seen in terms of their general purchasing power, not their purchasing power in relation to particular goods or services. Current value accounting and the Mathews recommendations would adjust costs in determining profits by reference to the actual current costs of goods of the same kind as those that have been sold. Such an adjustment reflects the theory that so much of the proceeds of realisation of goods as will need to be applied in acquiring other goods of the like kind to be held for sale, should not be diminished by tax if the operating capacity of the business is to be preserved. The recommendation of the Mathews Committee was that a “cost of sales valuation adjustment” should be allowed as a deduction, being the difference between the cost of stock held at the beginning of a year of income “at actual” prices, and the same stock at the same prices as closing stock, using actual price lists as the basis of calculation. The recommendation translates theory into a workable formula.

15.17 Current cost accounting theory also underlies the Mathews Committee recommendation in regard to adjustments to the cost of capital assets that are depreciable, in determining the amount that is an appropriate deduction in a year of income. The recommendation was that depreciation deductions should be indexed by way of a “depreciation value adjustment” using replacement cost of assets, the replacement costs being derived from a published index of replacement costs prepared by the Commissioner on the advice of the Australian Bureau of Statistics.

15.18 Another aspect of the Mathews recommendations that reflects their origin in current cost accounting theory, and not in an attempt to remove distortions affecting the equity of the income tax, is the proposal that when stock levels fall or the ownership of a business changes hands the cost of sales valuation adjustment should be reversed by the bringing in of a corresponding amount as income. With some want of consistency the Mathews Committee proposed that the depreciation value adjustment should be treated as bringing about a permanent deferral of tax.
There is also a want of consistency in the Mathews Committee recommendation that the stock valuation adjustment should not apply to livestock, nor to land, shares and other securities, and a want of consistency in the absence of any proposal that an allowance having the same function as the stock valuation adjustment should apply to the cost of work in progress that is not represented by physical stock, for example a solicitor's work in progress, or is not represented by physical stock that would appear as opening stock in a tax account, for example the cost to a farmer of planting a crop of wheat or the costs of building and construction work in progress.

The Australian Experience in Inflation Tax Accounting

The recommendations of the Mathews Committee led to limited legislative action, first operating in the 1977 year of income. The legislative action hovers between adjustments reflecting current cost accounting theory and adjustments reflecting a theory of inflation accounting that would seek to remove distortions that defeat the equity of the income tax.

The limited legislative response relates only to the Mathews Committee recommendation of a cost of sales valuation adjustment. The response was in provisions allowing a “trading stock valuation adjustment” increasing the cost of opening stock by the application of one half the percentage increase in the “goods” element of the consumer price index over the relevant year of income. The figure of one half, rather than the whole, was justified in terms of Government budgetary limitations. The provisions made up Subdiv. BA of Div. 3 of Pt III of the Assessment Act. The use of the consumer price index was generally at odds with current cost accounting theory, though there is some compromise in the reference only to the goods element. The consumer price index covers only consumer goods, and it may be thought a singularly inappropriate index in current cost accounting theory in some circumstances, though clearly appropriate if the concern is with the equity of the income tax.

The scope of Subdiv. BA of Div. 3 of Pt III was somewhat wider than the recommendations of the Mathews Committee. The cost of livestock was made subject to adjustment. One important difference from the Mathews recommendations was the absence of any provision to recover the amount of the accumulated adjustment in respect of the cost of stock, where stock levels were permanently reduced or the business was disposed of. Provision was, however, made so that the adjustment would apply to the cost of closing stock where there had been a permanent fall in
the level of stock during a year of income. A reconstruction provision, in s. 31C, was added so as to control the giving of an artificial cost to stock by acquiring it in transactions with associated taxpayers. That provision remains in the Assessment Act as a control on transfer pricing, though its operation is now lifted in international transfer pricing situations when Div. 13 of Pt III is applied.

15.23 The trading stock valuation adjustment provisions were repealed with effect from the end of the 1979 year of income. Events leading up to that repeal included an attempt by the Australian Accounting Standards Committee to persuade company directors to follow a provisional accounting standard issued in 1976 expressing current cost accounting. That standard required adjustments to financial accounts much like those proposed by Mathews for tax accounts. The level of compliance with the standard was minimal. An accounting standard that would depress companies' profits was not welcome, though tax accounting under the trading stock valuation adjustment provisions, which would depress companies' taxable incomes, had been welcomed by company management.

15.24 The trading stock valuation adjustment provisions had attracted criticism on a number of fronts. They were discriminatory in applying only to stock within a narrow definition of trading stock. And they were wanting in equity in not providing for the bringing in of gains that would arise on the discharge of monetary liabilities associated with the acquisition of the stock. The latter criticism puts equity ahead of a policy of protecting the operating capacity of a business entity. In abolishing the trading stock valuation adjustment Government drew attention to this want of equity, and pointed to the fact that business itself was not anxious to demonstrate in its financial accounts that it had suffered a loss of operating capacity: it had not embraced current cost accounting.

15.25 Meanwhile the Accounting Standards Committee had, in 1978, followed up the provisional standard for current cost accounting with an exposure draft on “Recognition of Gains and Losses on Holding Monetary Items in the Context of Current Cost Accounting”. The exposure draft provided for the recognition of losses and gains arising from the holding of monetary assets, and monetary liabilities other than loan capital, in the determination of entity net profit. Loan capital is defined as “borrowings for financing the operating capabilities of an entity”. It thus brought current cost accounting nearer to principles of tax accounting that would remove the equity distortions in the operation of the income tax in conditions of inflation. The exposure draft held to the view that a gain from the repayment of loan capital should not be brought to account in determining
entity net profit. It did however concede that such a gain should be recognised for the purposes of determining profits attributable to shareholders, and, presumably, the proprietors of a business. In this there is an acceptance that if equity between taxpayers is the objective, gains on the repayment of loan capital may need to be brought to account.

15.26 In 1983 the Accounting Standards Committee consolidated the provisional current cost accounting standard and the exposure draft into a Statement of Accounting Practice—something less, it seems, than an accounting standard. Business remains generally unwilling to accept any standard, or follow any stated practice. The level of compliance with the Statement of Accounting Practice is low.

The Feasibility of a Coherent Tax Accounting for Inflation

15.27 A coherent system of tax accounting for inflation must recognise gains on the discharge of liabilities. But its feasibility may be doubted. The monetary liabilities whose discharge should be held to give rise to a gain that arises from inflation may be identified. They are monetary liabilities that relate to the financing of a cost of a revenue asset, or a cost that attracts amortisation deductions, principally under the depreciation provisions; monetary liabilities that relate to monetary assets that may generate income from property; and other monetary liabilities whose costs of servicing would be deductible. There are two principles involved. The first is that an inflation gain in respect of a liability should be recognised in all circumstances where that liability may be said to have financed a cost that itself attracts an inflation adjustment; or to have financed the acquisition of a monetary asset that attracts an inflation adjustment. The second principle is that the deductible costs of servicing a liability are unreal to the extent that there is a countervailing gain on the discharge of the liability.

15.28 The identification of a liability that finances the cost of an asset employed in a process of derivation of income, or a liability that finances other costs of deriving income is discussed at length in [6.86]ff. above in relation to the deduction of interest. Those problems may not be insurmountable where the taxpayer is a company and there will, presumably, not be any borrowing for a private purpose. Where the taxpayer is an individual, the problems are acute. If tests in terms of tracing of money borrowed are to be applied, the taxpayer will seek to steer borrowed moneys away from an income producing purpose, wherever he has borrowed at a rate of interest less than the rate of inflation. He will assert that the borrowing was for consumption or to invest in an asset that
is not an asset held in any process of income derivation.
15.29 The assumptions in the preceding paragraphs are that an inflation adjustment will be applied to a monetary asset whether or not that asset generates income from property—interest, or a receipt in the nature of interest—and that an adjustment will be applied to a monetary liability, whether or not that liability does in fact have servicing costs. It is unlikely that a principle would be accepted that a taxpayer should be entitled to an inflation loss deduction in respect of the holding of a monetary asset where that holding does not in fact give rise to income from property. A taxpayer would enjoy a loss deduction by lending money interest-free. Indeed it would be good sense to hold that a taxpayer should be limited in determining his loss deduction arising from the holding of a monetary asset by the amount of income in fact derived from the monetary asset.
15.30 It may be more difficult to justify a principle that an adjustment that will produce a gain should be applied to a monetary liability only when that liability does in fact have deductible servicing costs and, where it does have deductible servicing costs, should be limited to the amount of those costs. But it might be argued that the element of gift that is involved in the receipt of an interest-free or low-interest borrowing should not be taxed.
15.31 Out of this discussion there will have emerged a further need to identify a borrowing beyond an identification that it relates to an income producing process. There is need to identify a borrowing as one that relates only to investment in monetary assets from which income from property may be derived. The burdens of identification press the prospect of achievement of a coherent system of inflation adjustments near to extinction.
Chapter 16: The Reconstruction of Tax Accounts

16.1 A number of provisions require or allow the reconstruction of tax accounts: they require or allow the Commissioner to tax on the basis of facts that did not occur but are deemed to have occurred. All assume that the operation of the Assessment Act on the basis of the facts that did occur would in some respect defeat the intention of the legislature, or what may be called the policy of the Act. The provisions would be said to be directed against tax avoidance, a phrase that is explained in [16.8] below.

16.2 Of these provisions, Pt IVA has the widest operation. Section 65 is directed to tax avoidance by shifting of income between associated persons as defined in the section. Division 6A of Pt III is directed more narrowly to tax avoidance by shifting of income derived from property. Division 13 of Pt III is directed to tax avoidance by shifting income between persons who do not deal at arm's length in international transactions. Each of these provisions has a manner of operation distinct from that of other sections which may also be seen as directed against tax avoidance. A number of these were considered in [10.289]–[10.362] above. They include ss 82KJ and 82KL, which operate, in a sense, to reconstruct a tax account by simply denying a deduction otherwise available to one party to a transaction. The provisions now to be considered require or allow that on the reconstruction of the tax accounts of one party to a transaction on the basis of facts that did not occur, there will be or may be a reconstruction of the tax accounts of another party to the transaction on the same basis.

16.3 A number of the provisions referred to in the preceding paragraph may be prima facie attracted by the same circumstances. Which provision is to be applied is the subject of some consideration in [10.313]ff. above. In general, Pt IVA may operate only where none of the other provisions has operated. The precedence among ss 65, 82KJ and 82KL depends on the provisions of those sections taken in conjunction with subss (3) and (4) of s. 177B. In the case of Div. 13, the precedence depends on the provisions of s. 136AB(1). In the case of Div. 6A precedence must rest on the concluding words of s. 102B(1) which, when s. 102B operates, requires that the income referred to “shall be treated for the purposes of [the] Act as if the transfer had not been made”. A transfer of income which is deemed by s. 102B(1) not to have occurred could not be one that will bring about a tax benefit as defined in s. 177C and thus could not trigger the reconstruction power given to the Commissioner by s. 177F of Pt IVA.

Reconstruction under Section 65
Section 65 was the subject of consideration in [10.310]ff. above. Its operation depends on the exercise of a function by the Commissioner by which he determines the extent to which the payment or liability incurred by a taxpayer to an associated person is reasonable. On that determination being made, the operation of the section is automatic. The taxpayer who made the payment or incurred the liability is entitled to the deduction, otherwise allowable, but only to the extent that the payment or liability is reasonable in amount (s. 65(1)). And, subject to s. 65(1B), the associated person to whom the payment was made or the liability incurred will, to the extent of the amount of deduction denied to the taxpayer, be deemed not to have derived income (s. 65(1A)). Section 65(1B), displacing to this extent s. 65(1A), will require that where the payment has been made or the liability has been incurred by a partnership in which a private company is a partner, the company shall be deemed to have paid a dividend of an amount ascertained in accordance with s. 65(1C). The consequences of this latter deeming are explored in [10.324] above.

**Reconstruction under Division 13 of Part III**

The operation of Div. 13 is considered in [10.359]ff. above. Reconstruction under s. 136AD depends on the exercise of at least two functions by the Commissioner, the first in reaching a satisfaction that the parties to an international agreement as defined in s. 136AC were not dealing with one another at arm's length, and the second in determining that the relevant subsection of s. 136AD should apply, if, as a matter of fact, the consideration received or given was less than an arm's length consideration. There is a third possible function on whose exercise reconstruction may depend. If it is not possible or practicable for the Commissioner to ascertain the arm's length consideration, the arm's length consideration is deemed to be such an amount as the Commissioner determines. The reconstruction is in other aspects automatic: the arm's length consideration is deemed to have been received or given.

Where the application of s. 136AD has resulted in an amount being included in the assessable income of a taxpayer, or has resulted in a taxpayer being denied a deduction, s. 136AF gives the Commissioner a power to reconstruct the tax accounts of another taxpayer, so as to exclude an amount from the assessable income of that taxpayer or to allow him a deduction. The general intention of s. 136AF is parallel with the intention of s. 65(1A). Reconstruction under s. 136AF depends, however, on the exercise of two functions by the Commissioner, while reconstruction under s. 65(1A) is in all respects automatic. The Commissioner must form an
opinion that the amount of income that is the subject of reconstruction would not have been included in the assessable income of the other taxpayer, had there been an agreement with the first taxpayer entered into at arm's length, and the Commissioner must form an opinion that it is fair and reasonable that the amount of income subject to reconstruction should not be included in the assessable income of the other taxpayer (s. 136AF(1)(a)). Similar provisions in s. 136AF(1)(b) apply in relation to the reconstruction of an allowable deduction available to the other taxpayer.

Reconstruction under Division 6A of Part III

16.7 The operation of Div. 6A of Pt III was considered in [13.82]ff. above. The reconstruction is in all respects automatic. It does not depend on the exercise of any function by the Commissioner. Where s. 102B operates, any income derived from property to which the section applies is to “be treated for purposes of [the] Act as if the transfer had not been made” (s. 102B(1)), and an amount equal to the income derived from property that is treated as not having been transferred is “deemed to have been paid by the transferor to the transferee at the time at which the income was paid to, or applied or accumulated for the benefit of the transferee” (s. 102C(c)(i)). And it is deemed to have been paid for the purpose for which it was in fact transferred (s. 102C(c)(ii)). The tax accounts of transferor and transferee must give effect to these deemings.

The Meaning of Tax Avoidance

16.8 Tax avoidance, as the phrase is used in discussion about tax, is a phrase of shifting meaning. It is at times used as a synonym for tax evasion, though a distinction between evasion and avoidance is a fundamental one. Evasion is the non-payment of tax when the law requires payment. The phrase tax avoidance is also used in a sense that is the one preferred in this Volume: the non-payment of tax when the law does not say that tax should be paid, though the policy of the law says that it should. The phrase is used in other senses. It is sometimes used in a sense that makes it a judgment on the policy in fact embodied in the law, a judgment made by someone who does not agree with that policy and would want to see a different policy embodied in the law. Thus the view is held by some people that capital gains should be subject to tax. That view may lead them to describe the sale of shares in a company that has accumulated profits as tax avoidance. In this instance the meaning of tax avoidance shades into yet another meaning which would identify tax avoidance with actions of
the kind that will attract the general provisions of Pt IVA of the Assessment Act. This last meaning would say that there is tax avoidance if a person acts in a way that justifies an inference that he acted as he did because he wanted, for himself or for another, the relief from tax that would attend his actions. There is tax avoidance in this sense even though neither the words of the law nor the policy of the law would say that his actions should give rise to a greater tax liability.

16.9 It may be helpful to consider in turn each of the provisions identified so far in this Chapter and to judge in what sense of the phrase they may be said to be concerned with tax avoidance.

16.10 Section 65 may be seen as an attempt to adapt the words of the law so that they might better express its policy. It is then a measure directed against tax avoidance in the sense of the phrase preferred in this Volume. The words of s. 51(1), in a number of decisions that have been the subject of discussion earlier in this Volume, have been given a meaning that is expressed in rules, including a rule that amounts to a rule of evidence, which lose contact with the policy of requiring relevance. A policy requiring relevance, it has been assumed, was sought to be achieved by s. 51(1). That loss of contact became evident in *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430. The manner of the attempt to restore the achievement of the policy of relevance goes some way, however, to expressing a new policy. The new policy may be thought to qualify a policy expressed in *Ronpibon Tin N.L.* (1949) 78 C.L.R. 47 that it is not for the Commissioner to tell the taxpayer how to run his business. A deduction is denied to the extent to which, in the opinion of the Commissioner, the amount of the payment made or liability incurred is not reasonable. The policy expressed in the principle requiring relevance is that a deduction is not allowable if the purpose of an outgoing is other than the gaining or producing of assessable income. It has been argued in this Volume that an inference of a purpose other than the gaining or producing of assessable income should be drawn where a payment exceeds what might be expected to be made in an arm's length transaction, and the parties are not in fact at arm's length. Section 65, at least in theory, goes beyond what has been argued for by contemplating the disallowance of the deduction of an outgoing to the extent that the Commissioner considers the amount paid is unreasonable. An unreasonable amount might yet be an amount that might be expected to be paid in an arm's length transaction.

16.11 Sections 82KJ and 82KL may also be seen as attempts to overcome tax avoidance in the sense of the phrase preferred in this Volume. They operate however at much greater cost to the policy of relevance than the cost that may be involved in the operation of s. 65. If the circumstances
attract the operation of ss 82KJ or 82KL no part of an outgoing will be allowed as a deduction. An operation of s. 51(1), if it were undistorted by the decisions in *Cecil, Europa Oil (N.Z.) Ltd v. C.I.R. (N.Z) (No. 2)* (1976) 76 A.T.C. 6001 and *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645, would in the circumstances with which ss 82KJ and 82KL are concerned have allowed some part of the outgoing as a deduction.

16.12 It is not intended to suggest that the rules established by the courts in *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers* were intended to express a policy different from the policy that requires relevance. Rather, judicial interpretation of s. 51(1) has lost contact with that policy, in the application of an approach described in this Volume as extended form and blinkers, and explained in [2.473]ff. and [9.17]ff. above. The analytical integrity of the law has in that interpretation suffered partial collapse. Sections 65, 82KJ and 82KL would all be unnecessary if *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers* were to be reconsidered and rejected. The patching over of the state of collapse which those sections effect can never be satisfactory. The collapse will express itself in areas beyond the patching. The restoration of the analytical integrity of the law is a matter for judicial action. Loss of analytical integrity of the income tax is not confined to the interpretation of s. 51(1). Other judicial decisions having this effect have been identified in other contexts in this Volume. The gloss on the concept of derivation reflected in the decisions in *McLaurin* (1961) 104 C.L.R. 381 and *Allsop* (1965) 113 C.L.R. 341 ([2.558]ff. above) involves a collapse. The decision in *Investment & Merchant Finance Corp. Ltd* (1971) 125 C.L.R. 249 ([2.449]–[2.451] above) involves the collapse of the concept of a business transaction, and defeat of one aspect of the policies of the income tax expressed in the concept of income. The collapse has been patched over by a number of complex sections (ss 46A and 46B) which are not directed at the seat of the collapse. Effectively they cannot be. Judicial action is called for. It is a matter of regret that given the opportunity in *Patcorp Investments Ltd* (1976) 140 C.L.R. 247 to restore the analytical integrity of the law, the High Court refused to accept it. The justification of that refusal given in the judgment of Gibbs J.—that amendments to the Assessment Act had taken care of the loss of integrity—was almost immediately shown to be unfounded. Further amendments, and greater complexity, were to follow. The decision of the High Court in *Curran* (1974) 131 C.L.R. 409 involves the collapse of the principles of tax accounting concerned with the determination of profit and loss, and the attendant policy that profit must be a real gain, and a loss deduction a real loss. The patching done by s. 6BA is not and cannot be adequate to restore the integrity of the law.
16.13 Division 13 of Pt III, like s. 65 and ss 82KJ and 82KL, is directed to overcoming tax avoidance in the sense preferred in this Volume. It is, in part, the avoidance that is made possible by the decisions in *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers.* *Europa Oil (No. 2)* was a decision on appeal to the Privy Council from the New Zealand courts. It confirmed an avoidance of tax by the shifting of income from a New Zealand company, in whose hands it would have been subject to New Zealand tax, to a Bahamas company in whose hands it was not.

16.14 Division 13 has a wider purpose. It will overcome the tax avoidance that will result if the actual proceeds of disposal of property or the actual amount paid in acquiring property in a transaction that is not at arm's length, are allowed to determine the amount of the gain or loss that is realised on a disposal. An Australian resident who sells goods to an associated non-resident for an amount that is less than an arm's length price will shift income otherwise subject to Australian income tax to another in whose hands it may not be subject to Australian tax. Division 13 is intended to defeat that shifting by requiring that an arm's length price be substituted.

16.15 In substituting an arm's length price for the amount paid, Div. 13 will go much of the way to overcoming the defeat of the policy of the law that results from *Cecil, Europa Oil (No. 2)* and *South Australian Battery Makers.* It may not go all of the way. It is arguable that in market conditions in which prices are fixed by a cartel arrangement, the price paid by a buyer in respect of the supply of goods or services is an arm's length price notwithstanding that the seller has agreed to confer benefits on the buyer, in exchange for that price, that go beyond the supply of the goods or services. Thus, the price paid for the oil in *Europa Oil (No. 2)* by the company that purchased from Gulfex might be described as an arm's length price, notwithstanding that the buyer also acquired by the payment a right to the diversion of a profit to the Bahamas company. Unless the function given to the Commissioner by s. 136AD(4) allows him to determine an arm's length price in such circumstances that is less than the price fixed by the cartel, s. 136AD will have achieved something less than overcoming the defeat of the policy of the Assessment Act.

16.16 At the same time s. 136AD may in some circumstances achieve more than overcoming the defeat of policy that arises from *Europa Oil (No. 2)* and *South Australian Battery Makers.* If those decisions come to be rejected by new judicial decisions there will yet be scope for income shifting by the payment of an excessive consideration. This is inherent in the absence of precision in s. 51(1). The assumption has been made that, unless the payment is substantially greater than the arm's length price, s. 51
(1) would need to accept the relevance of a payment between associated persons, in the absence of a showing of some distinct benefit, arising to the taxpayer or to another, beyond the supply of the goods or services to which the payment relates. Section 136AD may be seen as refining the law in its expression of the policy of relevance. At the same time it may be thought to share with s. 65 the prospect of some defeat of a policy that the law should not seek to tell a taxpayer how to run his business. The substitution of a price which the Commissioner considers to be reasonable, or to be an arm's length price, for the actual price paid will always threaten the latter policy.

16.17 Division 6A of Pt III is directed to preventing tax avoidance, in a meaning of tax avoidance that is not concerned with the failure of the law to express an existing policy. The enactment of Div. 6A involved an expression of a new policy. This new policy would limit the extent to which the Assessment Act allows the shifting of income. The general policy of the Assessment Act is that income derived by an individual or company taxpayer should be taxed as the income of that taxpayer. It will be taxed on a scale that takes into account only the amount of his income, though, in the case of an individual, rebates provided for in Subdiv. A of Div. 17 of Pt III may give significance to income derived by others in a family or other relationship with him. In the case of an individual the tax scale is progressive. In the result there is tax advantage overall to members of a group—most likely a family group—if derivation of income is spread over members of the group. It has been seen in the discussion of tax accounting that the Assessment Act allows some scope for members of a group to determine which member of a group will derive income, more especially by accepting the price charged for goods or services supplied by one member of a group to another. And an assignment of income, discussed in Chapter 13 above, may determine the member of a group who will derive income.

16.18 Precisely what is the new policy reflected in Div. 6A is not easily identified. It does not appear to be a policy that rejects the individual as the unit of income taxation. It is rather a policy directed against what is seen as the unfairness that some kinds of income—business and property income—are capable of being shifted while other kinds of income—more especially salary and wages—are not capable of being shifted, at least as the present law on derivation of income stands. The policy that may justify characterising assignments of income as tax avoidance is thus a curious one: one person should not benefit from the general policy of taxing on the basis of the individual as the unit of income taxation if another person cannot. Such a policy achieves only limited expression in Div. 6A. Thus,
the Division has no application in “relation to a transfer of a right to receive income from property where . . . the right arose from the ownership by the transferor of an interest in the property and the transferor has transferred that interest to the transferee or another person” (s. 102B(2)(b)). The shifting of income by transferring to another property whence income is derived is thus not inhibited by Div. 6A. And a shifting otherwise subject to the Division for a period beyond the prescribed period is not inhibited.

16.19 Division 6AA appears in the Act adjacent to Div. 6A which may suggest that their policies have at least some kinship. A detailed consideration of Div. 6AA, which is concerned with the defining of a class of income—certain income of minors—which is subjected to a special rate structure, is beyond the scope of this Volume. Some observations on the Division may, however, be appropriate. At first sight it may appear to be a limited expression of a policy of taxing the income of an individual by reference to his family circumstances, and to this extent a further qualification on the individual unit as the basis of income taxation. Such a policy was reflected in the recommendations of the Taxation Review Committee (Asprey Committee), in paras [11.9]–[11.14] of its Full Report (A.G.P.S., Canberra, 1975), which are some of the background of Div. 6AA. Yet the exceptions to the operation of Div. 6AA would indicate a different policy which does show a kinship with the policy of Div. 6A. The exceptions in the definition of income to which the Division applies, listed in ss 102AE(2) and 102AG(2), appear directed to excluding all situations in which the derivation of income by the minor could not be said to have been the consequence of a shifting of income undertaken to take advantage of the benefit that may flow from the general policy of taxing on the basis of the individual as the unit of income taxation.

16.20 So long as there is no definitive expression in the Assessment Act of a policy that would require the taxation of an individual by reference not only to his own income but also to the income of other members of his family group, there is no basis for an assertion that the tax advantages which flow from the mere fact of unequal distribution of income among members of a family group involve tax avoidance in the sense preferred in this Volume. Such tax advantages may be seen as involving tax avoidance only in the sense that they are contrary to policies which some people would wish to see expressed in the Act. The Asprey Committee recommended that the income of minor children living with their parents should be taxed in a way that brought their parents income into the reckoning (Full Report, para. [11.9]). And it recommended that spouses whose incomes are unequal should, by election, be able to have some of the tax advantage enjoyed by others whose incomes are more equal. Those

16.21 Part IVA of the Act has already been identified as concerned with tax avoidance in a meaning different from any of the meanings that will explain s. 65, s. 82KJ, s. 82KL, Div. 6A of Pt III and Div. 13 of Pt III as provisions concerned with tax avoidance, though there may be some reason to regard Div. 6A of Pt III as to a degree concerned with the Pt IVA meaning. The Pt IVA meaning may be caricatured: it is tax avoidance to pay less tax if the benefit of paying less tax was one that the taxpayer's actions were directed to securing, and this whether or not the policy of the law intended he should have that benefit. Division 6A may be thought to reflect the Pt IVA meaning in one respect. It is concerned with short term assignments of income from property that do not involve a transfer of the property from which the income is derived. It may be said that a taxpayer who makes an assignment of such a kind will generally have been moved by a wish to escape the payment of tax on the income he has assigned. But Div. 6A will defeat the tax benefit that would arise to the taxpayer from the assignment whether or not, in the particular circumstances of the assignment, an inference that the taxpayer's actions were directed to securing the tax benefit can be drawn, or, in the language of s. 177D of Pt IVA, whether or not “it would be concluded that the [taxpayer acted] for the purpose of [obtaining] a tax benefit”.

Reconstruction under Part IVA

16.22 The discussion under the last heading is directed to showing the different senses in which the phrase tax avoidance may be used when it is said of any aspect of the Assessment Act that it is directed against tax avoidance. The very special meaning the phrase has when it is said of Pt IVA that it is directed against tax avoidance has been identified.

16.23 Part IVA is most often described as the general provision of the Assessment Act directed against tax avoidance. In fact, Pt IVA does not use the phrase tax avoidance. Its language, in contrast with s. 260, the former general provision which does use the word “avoiding”, is “obtaining . . . a tax benefit in connection with a scheme” (s. 177C(1)). “Scheme” is given the very widest definition possible in s. 177A(1). And the Commissioner is given a function by s. 177F to deny a benefit by reconstruction of a tax account. He may deny the benefit if, having regard to listed circumstances, “it would be concluded that the person, or one of the persons who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling” the taxpayer who obtained the tax benefit to obtain that benefit, or of enabling that taxpayer and another
taxpayer or other taxpayers each to obtain a tax benefit (s. 177D). It will be noted that the idea of tax avoidance includes the obtaining of a tax benefit by a person who may not be the person of whom it would be concluded that he acted for the purpose of obtaining the benefit. A purpose in one person to obtain a tax benefit for another will make a benefit obtained by the other a benefit that is subject to denial by the Commissioner in the exercise of this function. “Tax benefit” is defined in s. 177C so that it is limited to (i) a benefit of an amount not being included in assessable income and (ii) a benefit of being allowed a deduction.

**Background: section 260**

16.24 Section 260 may be regarded as the predecessor of Pt IVA. It applies to “a contract, agreement, or arrangement made or entered into” before 27 May 1981. Part IVA does not apply to a “scheme entered into or carried out prior to 27 May 1981”. A detailed account of the interpretation of s. 260 is not proposed. The words of the section to which most of that interpretation has been directed are:

“Every . . . arrangement . . . shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—

(c) . . . avoiding any duty or liability imposed on any person by this Act . . .

be absolutely void, as against the Commissioner. . . .”

Three aspects of that interpretation require mention as background to an examination of Pt IVA.

16.25 One aspect is that the section did not give the Commissioner the power to reconstruct a tax account by adding any facts. He had no power to deem any facts to have occurred. The operation of the section was to annihilate facts as against the Commissioner. The Commissioner had power to assess only on the basis of “the facts that remained”. A too-close examination of the notion of facts that remained after the annihilation of other facts, might have led to a conclusion that once s. 260 had operated, the Commissioner could have no power to assess the taxpayer at all. Facts do not remain when associated facts are annihilated. At the least, they are changed. The courts did not however engage in a too-close examination. In Peate [1967] 1 A.C. 308, indeed, it might be said that the Privy Council approved a reconstruction of the facts by the Commissioner. The no-reconstruction aspect of the interpretation of s. 260 was, however, a constant threat to the usefulness of the section as a general provision against tax avoidance in any sense of the phrase. Part IVA, it will be seen, gives the Commissioner an express power of reconstruction, once it
appears that Pt IVA operates.

16.26 The second aspect concerns the meaning of “purpose of avoiding” as those words are used in s. 260. Newton (1958) 98 C.L.R. 1 confirmed that the purpose referred to was an objective purpose. It was a matter of inference from the circumstances. The passage from the judgment of Lord Denning in Newton constantly quoted in this regard is (at 8):

“In order to bring the arrangement within the section you must be able to predicate—by looking at the overt acts by which it was implemented—that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.”

This aspect of the interpretation of s. 260 has been retained in the drafting of Pt IVA, though the language of s. 177D differs from the language used by Lord Denning. It is a matter now of whether “it would be concluded” that a person who entered into or carried out the scheme or any part of the scheme “did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme”. It is necessary that it would be so concluded “having regard to” a number of listed circumstances, none of which involves the subjective purpose of a person to obtain a tax benefit for himself or any other person.

16.27 A consequence of this second aspect of the interpretation of s. 260 and its preservation in Pt IVA is that each is operative only in relation to tax avoidance, in a sense of the phrase which will describe not paying tax in circumstances where it can be inferred that someone wanted the consequence that tax would not be paid. The notion of tax avoidance involved may be caricatured by that description, but it is otherwise accurately described. It was enough to engage the operation of s. 260 that it could be inferred that one purpose of the arrangement was that tax would not be paid. At least this was the interpretation of the section in Newton though there is a reference in later cases to a requirement that the dominant purpose of the arrangement must have been that tax would not be paid. The effect of s. 177A(5) is that Pt IVA will be operative where there is more than one purpose in a scheme, only if the purpose that tax will not be paid is the dominant purpose.

16.28 A restriction on the drawing of the inference of purpose was written into s. 260 by the judgment of Barwick C.J. in Mullens (1976) 135 C.L.R. 290 at 302:

“Though the section speaks of the purpose in entering into the transaction, it can have no relevance if, being effective, the transaction does not alter the incidence of tax, as that expression has come to be understood. As I have already pointed out, there will be no relevant alteration of the incidence of tax if the transaction, being the actual transaction between the parties, conforms to and satisfies a provision of
the Act even if it has taken the form in which it was entered into by the parties in order to obtain the benefit of that provision of the Act. It would be otherwise if there had been some antecedent transaction between the parties, for which the transaction under attack was substituted in order to obtain the benefit of the particular provision of the Act. Section 260 is not directed to tax on income to which the taxpayer is entitled only by reason of the actual transaction into which the parties have entered.”

The restriction might be described as the false-start doctrine. An inference may not be drawn unless steps have been taken towards entering one arrangement, and there is thereafter a switch to another arrangement that will give a tax advantage. There are no words in Pt IVA that expressly reject the false-start doctrine in the interpretation of s. 177D.

16.29 The third aspect of the interpretation of s. 260 that requires mention is the “choice” doctrine, emphasised in the High Court judgments in W. P. Keighery Pty Ltd (1957) 100 C.L.R. 66 and later cases. The section would not make an arrangement void against the Commissioner if the taxpayer could be said to have been given by the Act a choice to enter into that arrangement. The choice doctrine was variously expressed. However expressed, it is a doctrine that precluded the operation of s. 260 if the tax consequences of the arrangement in question were consequences that the policy of the relevant provisions of the Act would approve. Thus, s. 260 did not operate in Mullens because there was no indication in the provisions of s. 77A, at the time the arrangement was entered into, that the deduction given by that section of the amount of a subscription for shares in a mining company should not be available unless the taxpayer both subscribed for the shares and continued to hold them for some period of time. Section 260 did not operate in Cridland (1977) 140 C.L.R. 330 because there was no indication in the provisions of s. 157 at the time the arrangement was entered into, that a taxpayer beneficiary of a trust that carried on a business of primary production should not have the benefit of the averaging provisions of the Assessment Act unless he was a substantial beneficiary. It followed that s. 260 was directed ultimately against tax avoidance in the sense preferred in this Volume, but was directed against it only in circumstances where it could be inferred that the taxpayer wanted the tax advantage that would otherwise flow from the failure of the words of the Act adequately to express their policy. The element in the interpretation of s. 260 that can be the subject of caricature was not excluded by the choice doctrine from the interpretation of s. 260.

16.30 There is some survival of the choice doctrine in the language of Pt IVA though the intention would appear to be that it should have only a very limited operation. Thus, subss (2) and (3) of s. 177C exclude the operation of Pt IVA where the tax benefit arises from the “making of a declaration, election or selection, the giving of a notice or the exercise of
an option by any person, being a declaration, election, selection, notice or
option expressly provided for by [the] Act”. It will follow that, subject to a
qualification, any tax benefit that may flow, for example, from the making
of an election as to the value of trading stock, provided for in s. 31, or in s.
36A, will not attract the operation of Pt IVA, even though it would be
concluded that the securing of that benefit was the dominant purpose in
making the election. The qualification arises from s. 177C(2)(b). The
operation of Pt IVA is not excluded if “the scheme was . . . entered into or
carried out by any person for the purposes of creating any circumstance or
state of affairs the existence of which is necessary to enable the
declaration, election, selection, notice or option to be made, given or
exercised . . . ”. The qualification is intended to cover the circumstances in
Westraders Pty Ltd (1980) 144 C.L.R. 55 and to let in the operation of Pt
IV A. The express provisions of subs (2) and (3) of s. 177C, giving a
limited operation in Pt IVA to the choice doctrine, is likely to be construed
as showing an intention that the choice doctrine is otherwise excluded. In
the result, Pt IVA is a bizarre exercise in law reform. It may deny a
taxpayer the tax benefit of a scheme if it would be concluded that the
dominant purpose of the scheme was to secure that benefit, even though it
was the evident policy of the relevant provisions of the Act to allow the
taxpayer that benefit. The discussion will return to this matter when some
more detailed account of the provisions of Pt IVA has been attempted.

The operation of Part IVA

16.31 A number of indications of the scope of Pt IVA emerge from the
opening observations in [16.22] above and from the comparisons with s.
260 drawn under the last heading. “Scheme” has a very wide meaning (s.
177A(1)). The fact that an inference can be drawn of purpose of one party
to a scheme to enable a tax benefit to be obtained by any taxpayer, may
lead to the denial of that tax benefit to that taxpayer, even though he was
not a party to the scheme (s. 177D). “Tax benefit” has a restricted
meaning—an amount not being included in assessable income or a
deduction being allowable (s. 177C). A scheme which involved taking
advantage of the averaging provisions, as in Cridland (1977) 140 C.L.R.
330, would not be a scheme to enable a tax benefit to be obtained. The
subjective purpose of a party to the scheme is, it seems, irrelevant: the
issue is always whether “it would be concluded that the person, or one of
the persons, who entered into or carried out the scheme or any part of the
scheme did so for the purpose of enabling the relevant taxpayer to obtain a
tax benefit in connection with the scheme” (s. 177D). The purpose so
inferred must be the dominant purpose (s. 177A(5)). There is, it seems, only a limited survival of the choice doctrine developed in relation to s. 260.

16.32 The wide meaning of scheme has implications for the operation of Pt IVA in regard to a plan of action that was “entered into” before 27 May 1981, and prima facie outside the operation of the Part (s. 177D). A step in the plan may have been taken after 27 May. In which case it is arguable that the step is a “scheme” entered into after 27 May and within the possible operation of Pt IVA, though presumably steps in the plan taken before 27 May could not be considered in drawing the inference of purpose that will make the scheme one to which the Part applies.

16.33 A number of questions arise in regard to drawing the inference of purpose. There is no direct reference in the drafting of Pt IVA to the “false-start” doctrine developed in relation to s. 260. No doubt the action of a person in first taking steps towards entering into one arrangement and then switching to another which is the scheme, may increase the prospect that enabling a taxpayer to obtain a tax benefit will be concluded to be the purpose of the scheme, though it is arguable that the steps towards entering on the first arrangement are not relevant to the drawing of the conclusion. The conclusion, it would be argued, must be drawn from the scheme. But it is unlikely that the false-start doctrine has survived to the extent that a conclusion of purpose to enable a taxpayer to obtain a tax benefit cannot be drawn, unless there were prior steps towards entering into an arrangement and then a switch to a scheme.

16.34 The scheme must be one that will involve a tax benefit, which is a reference in one aspect to “an amount not being included in the assessable income of [a] taxpayer of a year of income where that amount would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out” (s. 177C(1)(a)). It is arguable that those words are satisfied if the scheme involves the cessation of some existing process of income derivation, as a result, for example, of the transfer of a business by a sole trader to a trading trust. But it is hard to see how they can be satisfied if the taxpayer had no existing process of income derivation whose cessation was an aspect of the scheme—where, for example, he simply commenced business operations as the trustee of a newly established trust. In the latter case there would not appear to be any income of which it could be said that it “would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer . . . ” (s. 177C (1)(a)).

16.35 In its other aspect, “tax benefit” is a reference to a deduction “being
allowable to the taxpayer in relation to a year of income where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to have been allowable, to the taxpayer in relation to that year of income if the scheme had not been entered into or carried out” (s. 177C(1)(b)).

16.36 It is arguable that those words are satisfied if the scheme involves the cessation of some activity involving outgoings or losses that are not deductible and the substitution of activity which involves outgoings or losses that are deductible. But it is hard to see how those words can be satisfied if the taxpayer had no existing activity involving non-deductible losses or outgoings that it was part of the scheme to replace with new activity that would involve deductible losses or outgoings. It would follow that an activity of expenditure recoupment transactions of the kind that are now dealt with specifically in ss 82KJ and 82KL ([10.330]ff. above), would not be a scheme to obtain a tax benefit.

16.37 The definition of tax benefit may thus bring about limitations on the operation of Pt IVA. And there are other limitations on its operation which concern the drawing of an inference of dominant purpose to secure a tax advantage. The judgment of Lord Denning in Newton (1958) 98 C.L.R. 1 has been taken to contemplate a “business” purpose or a “family” purpose which is not a purpose to secure a tax advantage, even if tax advantage is a consequence of the action taken to achieve that purpose. The cases decided in relation to the operation of s. 260 constantly asserted the possibility. It appeared, however, that it was enough to attract the operation of s. 260 that an inference of a purpose to obtain a tax advantage was to be drawn, and the taxpayer had need to argue that any purpose that could be identified was not a purpose to obtain a tax advantage. The drafting of Pt IVA has opened the way to argument that even though an inference of two purposes is to be drawn, the business or family purpose is dominant and not the tax advantage purpose. There is a prospect of endless arguments about the inferences to be drawn.

16.38 A multitude of statements have been made by Government and by the Commissioner about Pt IVA, asserting it will not operate unless action has been taken that will give a tax advantage, and that action is “blatant, artificial or contrived”, but none of those words appears in Pt IVA. In any case what is artificial at one time may become natural when it is generally practised. The inference in Peate [1967] 1 A.C. 308 of a tax avoiding purpose depended to a degree on the fact that Dr Peate was a pioneer in the cause of a corporate structure to conduct a medical practice. In a number of New Zealand decisions on the interpretation of the New Zealand provision corresponding with s. 260, actions that were “unusual” and “extraordinary”
were pointed to as yielding an inference of a tax avoiding purpose. But the unusual and the extraordinary may in time become usual and ordinary.

16.39 It is for the taxpayer who denies the Commissioner's powers to reconstruct his tax account under Pt IVA to establish that no party to the scheme had a dominant purpose to enable the taxpayer to obtain a tax benefit. Taxpayer and Commissioner may be expected to engage in a competition of inferences that will indulge the imaginations of the parties. And subtleties about the notion of dominant purpose may be expected to be raised. Where more than two purposes are identified, the dominant purpose may be the most weighty of them, or it may be the purpose, if any, which alone outweighs all others.

16.40 The stakes in the competition of inferences are high. If the taxpayer fails to establish that his inference is to be drawn, whatever view is taken of the Commissioner's inference, the Commissioner will have the powers specified in s. 177F to reconstruct the taxpayer's account, involving the inclusion of an amount in the taxpayer's assessable income or the denial of a deduction.

16.41 Yet one might be moved to wonder about the point of the competition. If it is accepted that the choice doctrine, that was part of the interpretation of s. 260, has not, save in regard to elections expressly conferred, been carried into its provisions, Pt IVA lacks any rational justification. The presence of a purpose to enable a person to obtain a tax benefit may make some sense as a basis of selection of occasions when a tax benefit will be denied, if it is not within the policy of the law to grant that tax benefit. But it makes no sense whatever as a selector of occasions when a tax benefit will be denied, if that benefit is to be denied even though it is within the policy of the law to grant it. It makes no sense that the law should include incentive provisions such as those that the taxpayer sought to take advantage of in *Mullens* (1976) 135 C.L.R. 290 if Pt IVA will deny the taxpayer the incentive the law sought to give him, because he was foolish enough to act in such a way that it would be concluded that he wanted that incentive.

16.42 Where it is not within the policy of the law that the taxpayer should have a tax benefit, Pt IVA may serve a purpose of overcoming a failure of the law adequately to give effect to that policy, though one might wonder why the law should not in all circumstances be made to express its policy. But there can be no rational justification for provisions of the Act which enable the defeat of the law's policies. In the absence of a choice principle, Pt IVA confers a function on the Commissioner, by reconstruction of tax accounts, to give effect to policies of his own choosing. In this there is an abandonment of the rule of law. There is an abandonment even though one
might hope that the Commissioner will choose policies which are the policies of the law. This he might do by declining to exercise his function when there is no occasion to overcome a failure of the law to give effect to its policy. He would thus go some way to reinstating the choice doctrine. Indeed the choice doctrine could be substantially reinstated by a judicial decision that an exercise of the Commissioner's function under s. 177F(1) will not be valid unless it seeks to express the policies of the law.

16.43 Section 177F(3) gives the Commissioner a complementary function. Where he has exercised his function under s. 177F(1) to include an amount in the assessable income of one taxpayer, or to deny that taxpayer a deduction so as to deprive him of the benefit of a scheme, the Commissioner may exercise a distinct function to reconstruct the tax account of another taxpayer in a way that will treat the taxpayer as not having derived income which under the scheme he has derived, or will treat him as being entitled to a deduction to which, under the scheme, he would not be entitled. The reconstruction of the tax account of the other taxpayer is not automatic, as it is under s. 65 and Div. 6A of Pt III considered in [10.310]ff. and [13.82]ff. above. An automatic reconstruction would have assumed a principle that is clearly unacceptable. The derivation of income by one taxpayer does not have as a corollary that the person from whom he receives must be entitled to a deduction. And the non-deductibility of a payment by one taxpayer does not have as a corollary that a person who receives the payment does not derive income. The automatic reconstruction that results from the operation of s. 65(1A) does assume such a corollary. A taxpayer may make a payment to an associate, which is denied deduction, in part, by s. 65(1) as a payment of an unreasonable amount. It does not follow that the element of the payment that is unreasonable cannot be income of the receiver. It may yet, for example, be a reward for his services. An unreasonable payment for goods supplied by a relative may be a way of rewarding a relative for some service without exposing him to tax on the reward.

The place of section 177E in Part IVA

16.44 In s. 177E, Pt IVA includes a section which highlights the vague and often inappropriate ideas which underlie the other provisions of the Part. In Slutzkin (1977) 140 C.L.R. 314, the High Court had held that s. 260 did not operate to prevent the securing of a tax advantage by selling shares in a company with accumulated profits, when those profits might have been taken out as dividends or by liquidating the company. The proceeds of sale of the shares by the owner of the shares will generally reflect capital gains
that are not income. A dividend out of accumulated profits, or a distribution on liquidation so far as it represents income derived by the company, will be dividends and income of the owner of the shares. The shareholders in Slutzkin had “cashed up” their company prior to the sale of their shares: the company had sold its assets, and its share capital and reserves were now represented by cash. Though they might have suspected it, the shareholders who sold were not parties to the purpose of the company acquiring the shares, a purpose to move the company whose shares had been acquired to pay dividends that would absorb its reserves. The company that had acquired the shares, thereafter sold the shares. The company acquiring the shares was a sharetrader, and would be described as a dividend stripper. The advantages for such a stripper attendant on the stripping and on-sale of the shares were substantial at the time of the events in Slutzkin. Those advantages arose from the decision of the High Court in Investment & Merchant Finance Corp. Ltd (1971) 125 C.L.R. 249, a decision that has been identified in this Volume as one destructive of the analytical integrity of the Assessment Act, and for this reason giving rise to defeat of its policies. The advantages for the stripper have now been taken away by specific amendments to the Act in ss 46A and 46B, though the appropriate response ought to have been, and ought still to be, the overruling by the High Court of its decision.

16.45 The advantage for the original shareholders in a Slutzkin sale of their shares continued despite ss 46A and 46B, though finding a stripper who would pay an attractive price for their shares may have become more difficult. Part IVA is clearly intended to confer a function on the Commissioner by which he might take away the tax advantage for the original shareholders in a Slutzkin situation. If that function is not given by the general provisions, then it is given by s. 177E. The decision in Slutzkin on s. 260 does not of course exclude the application of the general provisions of Pt IVA to any tax benefit to the original shareholders. But the application of the general provisions is doubtful. It may be doubted that there is a tax benefit. It is arguable that it could not reasonably be expected that dividends would have been paid by the company to its original shareholders, or that the company would have been liquidated by the original shareholders had they not entered on the scheme to sell their shares. If there can be said to be a tax benefit, it may be doubted that it would be concluded that a party to the scheme of selling the shares, or the scheme of sale, purchase and stripping, acted with a dominant purpose of enabling the original shareholders to obtain that benefit. And if there is any survival of the choice doctrine to be found in Pt IVA, it may be doubted, s. 177E aside, whether there is any policy of the law that shareholders in the
situation of the original shareholders in *Slutzkin* should be held to derive income on the sale of their shares. The separate system of taxing company and shareholder adopted by the Australian law involves two levels of taxation, one at the company level and another at the individual shareholder level, when income moves through a company intermediary in its derivation and in its distribution to shareholders. It is arguable that the two levels of taxation operate to produce an unfair result if all income derived by the company is distributed to its shareholders, and it cannot be the policy of the law in any circumstances to treat the shareholder as if a full distribution had been made of income that has been taxed at the company level. To tax that element in the proceeds of sale of shares that reflects the accumulated income of the company is to treat the shareholder as if he had retained his shares and a full distribution had been made.

16.46 A concern that the general provisions of Pt IVA would not give the Commissioner a function to reconstruct the tax accounts of shareholders in a *Slutzkin* situation explains the enactment of s. 177E. Section 177E deems a *Slutzkin* situation to be a scheme to which Pt IVA applies and it deems a tax benefit to have been obtained of an amount that is specified. The view taken in this Volume is that there is no rational justification for selecting the occasions when the Commissioner will have a function to reconstruct tax accounts by reference to the appropriateness of an inference that some person has acted for the purpose of enabling a taxpayer to obtain a tax benefit. It is more than bizarre to deem it appropriate to draw such an inference in order to give the Commissioner a function to reconstruct.

16.47 Section 177E must be explained as an attempt to assert some new policy that would extend the scope of gains that are subject to the income tax. But the new policy is virtually undiscoverable from the terms of the section. Section 177E(1)(a) provides what key there is. There must have been a disposition of property of a company “as a result of a scheme that is, in relation to [the] company—(i) a scheme by way of or in the nature of dividend stripping; or (ii) a scheme having substantially the effect of a scheme by way of or in the nature of a dividend stripping”.

16.48 Section 177E(2) in defining “disposal of property of a company” requires that “dividend stripping” be understood in a sense that is wider than what would appear to be its meaning in s. 46A. “Asset stripping” might have been a more appropriate phrase, and the word “stripping” suggests a substantial disposal of property. If the section is to operate, the disposal must be one that “in the opinion of the Commissioner . . . represents, in whole or in part, a distribution (whether to a shareholder or another person) of profits of the company . . .” (s. 177E(1)(b)). And the amount which in the opinion of the Commissioner represents a distribution
must be such that it “would have been included, or might reasonably be expected to have been included . . . in the assessable income of a taxpayer . . . if, immediately before the scheme was entered into, the company had paid a dividend out of profits of an amount equal” to that amount, and it would have been included, or might reasonably be expected to have been included in the assessable income of the taxpayer, “by reason of the payment of that dividend” (para. (c) of s. 177E(1)). If all conditions are satisfied the Commissioner will have a function to reconstruct the taxpayer's account under s. 177F so as to include the amount in his assessable income.

16.49 Linking s. 177E with s. 177D by the pattern of deemings leaves the Commissioner with a function to include the amount in the taxpayer's assessable income, which opens up the prospect already discussed that the Commissioner may act in accordance with policies of his own choosing. This weakens whatever policy is sought to be expressed in s. 177E in a way that makes it impossible to identify it. If the conditions for the operation of s. 177E are met one might have expected that operation to proceed by simply making the relevant amount assessable income of the taxpayer, not by a number of deemings that will give the Commissioner a function to include the amount in the taxpayer's assessable income. If the reason for an operation by way of deemings was to attract the prospect of reconstruction of the account of another taxpayer by way of complementary tax relief under s. 177F(3), that reconstruction should have been accomplished by distinct provisions.

16.50 The taxpayer whose tax account is made subject to reconstruction by s. 177E may be a taxpayer in the position of the original shareholders in Slutzkin (1977) 140 C.L.R. 314, and it is in relation to the tax consequences for such a shareholder that s. 177E may be said to express a new policy. But there are difficulties in interpreting the section in a way that will subject such a taxpayer to reconstruction. The disposal of property must have been made “as a result of a scheme that is, in relation to [the] company . . . a scheme by way of or in the nature of dividend stripping” and the condition imposed by s. 177E(1)(c) that the taxpayer might have had an amount included in his assessable income, must be judged by reference to a notional dividend out of profits “immediately before the scheme was entered into”. The fact that the taxpayer is not a party to the scheme will not affect the operation of s. 177E, but the fact that the scheme commences some time after the taxpayer has ceased to be a shareholder will affect its operation in relation to a taxpayer in the position of an original shareholder in Slutzkin. It may be asked whether “a scheme that is, in relation to a company, a scheme by way of or in the nature of dividend
stripping” will include the acquisition by a new shareholder—the dividend stripper—of the shares in that company. At least when the decision to strip is taken by the new shareholder after the acquisition of the shares, s. 177E will not operate to give the Commissioner a function to reconstruct the accounts of shareholders who are otherwise in the position of the original shareholders in *Slutzkin*. Section 177E(1)(c) will in those circumstances confine the Commissioner's function to a reconstruction of the tax account of the dividend stripper. Perhaps it is the policy of s. 177E that the Commissioner's function should be so confined, but this leaves adverse tax consequences for a shareholder who sells to a dividend stripper dependent on decisions having been taken by the stripper before the sale. It is hard to see what conceivable policy would justify imposing adverse tax consequences on the seller by reason of a state of mind of the dividend stripper at the time of the latter's acquisition, when the seller need not have had any knowledge of that state of mind at the time he sold. The search for the new policy that will explain s. 177E becomes exhausting, and with little hope that it will be fruitful.

16.51 The taxpayer whose tax account is made subject to reconstruction by s. 177E may be the dividend stripper where the company has made a disposal of property to the stripper or to its associate. In this aspect of its operation, s. 177E reflects a policy already evident in s. 108 of the Act. A detailed examination of the Assessment Act in relation to company distributions is not within the scope of this Volume. It is enough to say that a distribution which is not in form a dividend paid to a shareholder from company profits, may yet be income of a person with an interest in the company. Section 177E may add to the expression of an existing policy by giving the Commissioner a function to identify a company distribution in a disposal of property by the company.

**The Extent of Achievement of the Policies of the Income Tax**

16.52 There will be general agreement that the income tax should secure the achievement of its policies. The extent of its achievement will always be limited by the amount of evasion—the failure to pay tax when the law requires payment. And the extent of achievement will be limited by the amount of tax avoidance in the sense of the phrase as it is used in this Volume—the failure to pay tax where the law does not require payment because it is deficient in the expression of its policies. The policy of the law may be identified with the intention of those who made the law—those involved in the processes of legislation.

16.53 Some evasion is overt. The Commissioner simply does not insist on
compliance with the law, because it appears that the law does not accord with its policy. In which event evasion contributes to the achievement of the policies of the law. The Commissioner has been less than rigorous in demanding compliance with the law in regard to the taxing of fringe benefits, more especially in the cases of low-interest loans allowed to employees, company cars, discounted goods and services and employer-provided accommodation at less than market rental. In all these illustrations there may be room for debate about the policy of the law. In the last instance the addition of ss 26AAAA and 26AAAB was found necessary to reframe the law to make it accord with its policies, or perhaps to adopt new policies dictated by a response by taxpayers to old policies.

16.54 Tax evasion may be covert. Tax is escaped by a taxpayer who fails to return income he has derived. The failure may be innocent, or it may be with the intention of ensuring that tax known to be payable is not paid. The failure to return income derived in the so-called “cash” or “hidden” economies is the principal illustration. Tax evasion may be defiant—the failure to pay tax known to be payable accompanied by steps taken to ensure that the Commissioner cannot recover the tax. The failure to pay tax payable by companies that were the focus of bottom-of-the-harbour operations in the late 1970s is the principal illustration.

16.55 Tax avoidance is the greater, the more the law fails to express its policies. The extent of that failure will reflect in part the approach taken by the courts to the interpretation of the law. On one approach the law speaks in its terms. On another the law is only the mouthpiece of its policies. On the latter approach there will be a failure of the law to express its policies only if the policies are mistaken by the courts in interpreting the law. The provisions of ss 15AA and 15AB of the Acts Interpretation Act remove inhibitions that the law previously imposed on courts in making a search for those failures. If no policy is found there will be no law and there can be no tax avoidance. In fact the law will always be treated to some extent as speaking in its terms, at least when no policy can be found. When no policy can be found, there can be no tax avoidance. There can be tax avoidance only when the law is held to speak in its terms and its terms are at odds with its policy.

16.56 There will always be differences in the emphasis given by judges to an approach that the law speaks in its terms. Some judges may come near to asserting that the law always speaks in its terms, and that a search for policy should not be pursued lest the law in its terms be distorted by its policies. Maintaining such an approach may have been rendered more difficult by the express direction to the courts now given by s. 15AA of the Acts Interpretation Act that “construction that would promote the purpose
or object underlying the Act shall be preferred to a construction that would not promote that purpose or object”. But if a judge takes the view that only one construction is possible, the direction may be ignored.

16.57 An emphasis in interpretation on an approach that the law speaks in its terms has produced some remarkable opportunities for tax avoidance. The starkest illustration is *Gorton* (1965) 113 C.L.R. 604, a decision on the interpretation of the now abandoned federal gift duty. There is no equivalent illustration in the field of the income tax. There is a view that an insistence that the law speaks in its terms is an aspect of the achievement of values said to be expressed in the idea of the rule of law. *Gorton* would be seen as a demonstration of those values, a demonstration that loses its virtue only if the law is left unamended to continue to speak in its terms when its terms are evidently at odds with its policies. *Gorton* was left uncorrected by any change in the terms of the law until the tax itself was abolished.

16.58 The extent of the failure of the law to express its policies may reflect another aspect of the interpretation of the law. It is a task of judicial interpretation of the tax law to draw out the implications of broad principles which are expressed in the words of the law. Where the rules that are framed in drawing out the implications of broad principles come to be a contradiction of those principles, the law will come to be at odds with its policies, and opportunities for tax avoidance as stark as that created by *Gorton* will come to be available. A rule that contradicts the principle whence it claims to be drawn is destructive of the analytical integrity of the law. It is not a demonstration of the rule of law—it is a rejection of it. It has no virtue. Its correction is an immediate need, and the correction is for the court that made the rule. Correction by legislation to restore the achievement of the policies of the law can never be complete, and it will be at the cost of considerable addition to the complexity of the law.

16.59 A number of decisions of the High Court have been identified in this Volume as destructive of the analytical integrity of the income tax. They are (i) *McLaurin* (1961) 104 C.L.R. 381, and more especially *Allsop* (1965) 113 C.L.R. 341, in regard to the apportionment of a receipt between income and non-income elements: they contradict the income character of the income element; (ii) *Investment & Merchant Finance Corp. Ltd* (1971) 125 C.L.R. 249 which contradicts fundamentals of the concept of a business; (iii) *Cecil Bros Pty Ltd* (1964) 111 C.L.R. 430 and *South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645 which contradict the principle of relevance, an aspect of the concept of a deductible outgoing expressed in s. 51(1); and (iv) *Curran* (1974) 131 C.L.R. 409 which contradicts the most fundamental of concepts—that income is a gain.
and that deductible loss reflects a real loss.

16.60 Attempts by legislation to stem the tax avoidance that has flowed from each of these decisions have been made in all instances, save the first. All attempts have been no more than patching a framework that is in a state of partial collapse. The patching in all cases leaves the prospect of further collapse. In the case of Investment & Merchant Finance the patching has dealt, in ss 46A and 46B, only with some manifestations of the collapse. It is a sad event in the judicial process that this patching was seen by the High Court in Patcorp Investments Ltd (1977) 140 C.L.R. 247 as a reason why it should not undertake a reconsideration of the correctness of its decision. The attempts at legislative correcting of Cecil and South Australian Battery Makers by ss 82KJ and 82KL have added immensely to the complexity of the Act. They are draconian, arbitrary and yet inadequate. The attempts at legislative correction of Curran in s. 6BA are inadequate. They do not deal with rights issues and option issues. They cannot in any case anticipate all the points of further collapse that Curran may generate. The restoration of sound structure by a High Court reversal of Curran is mandatory.
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