Case Study: Income Tax Consequences of Various Transactions

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Abstract

This paper is an analysis of the case study provided. It seeks out the income tax consequences of the various scenarios outlined in the fact pattern. To this end, it explores the concepts of income tax, ordinary income, derivation, interests on savings accounts and mortgages, the cash basis and accrual methods of accounting, unusual transactions and windfall gains. It examines the relevant laws that relate to the aforementioned concepts and applies the law to the presented scenarios. The paper is a result of desk-based research with particular reliance placed on the Income Tax Assessment Act of 1997, relevant case law and secondary research.

Income Tax

Section 4-10(3) of the *Income Tax Assessment Act 1997* (Cth) (*ITAA)* provides that an entity's income tax is determined by finding the difference between the product of its taxable income and tax rate and, its tax offsets. Section 4-15 provides that the taxable income is determined by finding the difference between the accessable income and any permissible deductions. Assessable income means that income that is potentially taxable while allowable deductions are the expenses that accrue from the process of making accessable earnings (CPA Australia, 2011). The Act's Section 6-1 further provides that accessable income is made up of both ordinary and statutory income. Section 6-5 defines ordinary income to include income according to 'ordinary concepts' (ITAA, 1997). The section further provides that for Australian residents, assessable income includes ordinary income directly or indirectly derived from all local or external sources during the income year. Section 6-5(4) further stipulates that ordinary income is considered to be derived when received and such receipt manifests the moment it is dealt with according to the taxpayer's directions or in any way on his behalf. This provision embodies the doctrine of constructive receipt.

Ordinary Income

Three principles must be applied in identifying ordinary income. First, the determination must be premised on ordinary concepts and usages of mankind (*Scott v Commissioner of Tax,* 1935; Australian Tax Office Tax Ruling 1999/17). Second, a consideration of the particular facts of every case coupled with an examination of the nature of the receipts from the receiver's point of view must be made (Australian Tax Office Tax Ruling 1999/17). Third, the determination must be made in an objective manner (Australian Tax Office

Tax Ruling 1999/17). Parsons (1985) identified other preconditions and traits that courts have developed as devices used in identifying whether received payments are ordinary income. The prerequisites are that there must be an accrual of real profit (*Hochstrasser v Mayes,* 1960), and the profit must be in monetary form or a form that is convertible into money (*Federal Coke Co Pty Ltd v FC of T,* 1977). Other traits attributable to ordinary income include the frequency and the flow of the receipts and the nature of the activities that generate the receipts (Parsons, 1985). Salary and wages due to employees are ordinary income hence assessable (Ato.gov.au, 2015).

In *FCT v Cooke and Sherden* (1980), the court concluded that receipts that cannot be converted to money or transferred to third parties do not qualify as income according to ordinary concepts. This precondition is premised on the notion that where receipts cannot be converted to cash, the receiver does not get any benefit or profit hence there is no ordinary income (Barkoczy, Rider, Baring & Bellamy, 2010). However, section 15-2 of the *ITAA97,* a provision of statutory income, makes receipts arising from personal services that are neither cash nor convertible to cash assessable.

Derivation

Derivation means obtaining, getting or acquiring a payment (*FC of T v Clarke,* 1927). Parsons, affirming Dixon J in *Carden's case,* asserts that derivation manifests when income 'comes home' to an entity (1985). Therefore, the income must be realized or be immediately realizable in the particular financial year to constitute ordinary income. The principles governing derivation were established in *Commissioner of Taxes (SA) v Executor Trustee and Agency Co of South Australia Ltd* (1938). Also known as *Carden's case,* the issue of concern was which method, either the cash-based or the accrual method applied to a professional who is accounting for income. The court concluded that an entity must adopt the accounting method that is most appropriate in the circumstances and to be appropriate, an accounting method must be the one that gives a ‘substantially correct reflex’ of an entity’s true income. Remuneration from employment is ordinarily assessable on a cash basis (*FC of T v Firstenberg,* 1976).

Jones is a part-time employee of the University. His $42,000 annual salary is ordinary income as prescribed under section 6-5 hence constitutes his assessable income. As salary, the cash basis is the most appropriate method of accounting The doctrine of constructive receipt becomes operative every time his salary is paid into his savings bank account according to his arrangement with his employer because it is done pursuant to his instructions. He uses the account to settle household expenses. Consequently, no allowable deductions are applicable to his salary. Household expenses do not represent any expenses incurred in the process of generating income that is assessable.

Interest on Savings Account

The interest that has accrued on savings in a bank account is income according to ordinary concepts hence ordinary income as prescribed under section 6-5 (Gilders, Taylor, Walpole, Burton & Ciro, 2015). The general rule is that for tax purposes, interest is derived when it is credited to the bank account (Australian Tax Office Tax Ruling 98/1). Therefore, the cash basis is the accounting method appropriate to determine a taxpayer’s assessable income. Suffice to note that interests on mortgage agreements do not amount to allowable deductions under the income tax regime. Therefore, any amounts used to settle mortgage interests cannot be claimed to reduce an entity’s tax liability.

Interests earned from his savings account are also assessable because they satisfy the ordinary income threshold set under section 6-5 of the *ITAA97*. Interests are gains derived from bank savings hence constitute income. Following the general rule, interest is derived the moment it is credited to the savings account hence the cash basis is the appropriate method of accounting. As earlier mentioned, interest from mortgage arrangements does not qualify as an allowable deduction. Therefore, the arrangement that Jones has with the bank to offset any interests from the savings account against any interests on his mortgage does not preclude the savings account interest from assessability. Consequently, the $300 that accrued and was offset against his mortgage is assessable income.

Methods of Accounting: Cash or Accrual Method?

Section 995-1 of the *ITAA97* defines the term business to include 'any profession, trade, employment, vocation or calling' with the exception of an occupation as an employee. Proceeds from a business constitute income according to ordinary concepts hence ordinary income under section 6-5 (*Californian Copper Syndicate (Limited and Reduced) v Harris,* (1904). For entities that are business taxpayers, the general rule is that the accrual method is the most appropriate method of accounting (*Henderson v FCT,* 1970). However, in *FCT v Dunn* (1989), the court recognized that the accruals method may not be the most suitable accounting method for all business taxpayers. The rule is that the accrual method is the most appropriate for business taxpayers unless, in the circumstances, it is 'artificial, unreal and unreasonably burdensome' way of determining derived income (*FC of T v Firstenberg,* 1976). Factors to consider in determining the method of accounting include the size of the business, the number of employees and clients, the extent of the taxpayer's involvement and personal exertion and the nature of the products the taxpayer deals in (Australian Tax Office Tax Ruling 98/1).

Jones’ practice is a business entity. The general rule is the accrual method of accounting is the most appropriate for business taxpayers. However, following *Firstenberg Case,* the accrual method can be avoided by a business taxpayer in circumstances where it is an ‘artificial, unreal and unreasonably burdensome’ way of determining derived income. In Jones’ case, he runs a small practice. Further, on the facts, he receives a substantial amount of payment for services offered within the same income year. On the facts, the accrual basis is an unrealistic and unreasonably burdensome method of determining derived income. The cash basis is the most appropriate method of accounting in the circumstances. Therefore, the return will be based on the $30,000 received because it is the only assessable amount. The $5000 that is outstanding from the 2015/15 income year as well as the $3,000 received from outstanding 2013/14 accounts are not assessable because they have been derived. With regards to the free air tickets, they were given in March 2010 hence not a subject for the 2014/15 income year. In any case, the tickets are not convertible to cash and not using them would result in their being wasted. Therefore, they do not satisfy a prerequisite of income hence they are not assessable.

Partnerships

People who jointly receive income qualify as partners for tax purposes (ITAA, 1997). There must be a business venture, joint receipt of the income and mutual agency for a partnership to subsist (*FCT v McDonald,* 1987). To qualify as income, the receipt must either be a profit from a business that is ongoing or a profit from an unusual transaction by entities that are already in business (Gilders, Taylor, Walpole, Burton & Ciro, 2015). Income generated from licences, and any other arrangements are income according to ordinary concepts. As a business entity, the most appropriate method of accounting for a partnership is the accrual method unless there are other factors that make it the unsuitable method.

The joint development of the software makes Jones and his wife partners. Therefore, any income received from the use of the software is accessed according to partnership taxation principles. The $17,500 received from the licensees as well as the $25,000 payment for the exclusive rights to the software constitute ordinary income hence assessable. As a business venture, the accrual method is the most appropriate method of accounting.

Unusual Transactions

In *FCT v Myer Emporium* (1987), the court concluded that a recurrence of undertakings or continuity of operations must be apparent in determining whether there is a business capable of generating assessable income. Business entails an organized sequence of frequent activities. Any profits made from these activities will ordinarily be assessable as income. However, in *FCT v Whitfords Beach Pty Ltd* (1982), the court also recognized that gain realized from an unusual venture or an isolated transaction will be considered as income if the assets producing the gain were acquired in the course of a business operation or commercial transaction. This is so where it is apparent that the extraordinary venture was pursued with the intention of making a profit (*FCT v Myer Emporium*, 1987).

Jones' transactions regarding the old share certificates make up isolated transactions because he is not in the business of acquiring and selling old share certificates for profit. However, even though an isolated transaction, the facts show that Jones embarks on the collection of the certificates with an intention to sell them. In acquiring them, he thinks that they could be marketable as decorative features to hang in solicitors and accountants offices. Therefore, Jones had the intention to make a profit from these old share certificates. Therefore, following *FCT v Myer Emporium Ltd* (1987) any income that would be derived from the sale of the certificates qualifies as business income hence assessable. The cash basis is the appropriate method of accounting in the circumstances. All expenses incurred in the transaction are deductible because they are outgoings that are necessary for the generation of assessable income. If sold, the certificates would fetch $1000 each hence total sale would be $500,000. 10% of these is Harman's commission hence Jones receives $450,000. All expenses incurred in the venture are allowable deductions. Jones' expenses are $500 which is the initial cost of purchase and $50,000 which is the cost for framing, numbering and inscription. Therefore, received cash, $450,000 less deductions, $50,500 means that $399,500 is the assessable income.

Windfall Gains

Windfall gains such as prizes, winnings from gambling and other receipts from participation in contests and competitions do not meet the ordinary income threshold (*Prince v FCT*, 1959). They are not considered as income because the element of exertion or labor lacks hence they are not earned. Jones is a one-off winner of the quiz show. Winnings from the quiz show are not earned. The general rule is that receipts that are unearned do not constitute income. Accordingly, the receipts constitute a windfall gain that is not assessable as income. Therefore, the $200,000 cash as well as the $30,000, which is the value of the car, are not assessable hence not subject to tax.

Conclusion

Jones' assessable income for the 2014/2015 income year comprises of his salary from the university and the interest that accrues on the savings account. Income from his practice, as well as proceeds from the use of the software also, constitutes assessable income. Further, any proceeds from the sale of the old share certificates would qualify as assessable income in the circumstances. However, winnings from the quiz show represent a windfall gain. Windfall gains do not qualify as income according to ordinary concepts. Therefore, prize winnings are not assessable. Further, the free tickets may not be assessable as ordinary income because they are not convertible to cash although they may be categorised as statutory income under Section 15-5 of the *ITAA97.*

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