

Introduction

The issues for determination presented by the fact pattern revolve around the question whether the particular instances in Beverly's transactions have an income tax effect. To this end, the paper determines whether her compensation for the alteration of the contract of employment and the payment for signing the restrictive covenant have an income tax effect. Further questions for determination are whether the payment for acting as a surrogate and the receipt of the diamond ring from the couple has any income tax effect. Finally, it also determines whether the costs associated with the office and the payment for defending the claim of negligence have any income tax effect.

Defining Income

Lord Macnaughten famously defined income tax in *London County Council v Attorney General*¹ as 'tax on income.'² Unfortunately, the concept of income is not clearly demarcated.³ Clark suggests that this problematic state of affairs is due to the legislature's lack of clarity in the statutory definition hence there is no comprehensive definition of the term income.⁴ The income tax payable by an individual is the difference between the product of his taxable income and tax rate and his tax offsets.⁵ The taxable income is the difference between the accessible income and the allowable deductions.⁶ The *Income Tax Assessment Act 1997* (Cth) (*ITAA97*) provides that accessible income comprises of both ordinary and statutory income.⁷ Assessable income denotes

¹ [1901] 4 TC 293.

² *Ibid* at 293.

³ R W Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (The Law Book Company Limited, 1985).

⁴ Braedon Clark, 'The Meaning of Income: The Implications of Stone V FCT' (2004) 14 *Revenue Law Journal*.

⁵ *Income Tax Assessment Act 1997* (Cth) s 4-1.

⁶ *Ibid*

⁷ *Income Tax Assessment Act 1997* (Cth) 6-1(1).

a taxpayer's income that is possibly chargeable.⁸ Allowable deductions are expenses incurred in the process of generating assessable income.⁹ The Act also provides that some ordinary and some statutory income may make up exempt income¹⁰ and that exempt income is not assessable income.¹¹ Further, some ordinary and statutory income is both non-assessable and non-exempt¹² and income, either ordinary or statutory, can only fit in one category.¹³ Therefore, it can either be assessable, exempt or non-assessable non-exempt income.

Ordinary Income

Ordinary income is defined as 'income according to ordinary concepts.'¹⁴ For Australian residents, it includes ordinary income directly or indirectly derived from all sources in or out of Australia in any given financial year.¹⁵ Jordan CJ in *Scott v Commissioner of Tax*¹⁶ held that income must be perceived according to 'ordinary concepts and usages of mankind' except in situations where there is an express statutory provision stipulating otherwise. The court concluded that income is not a term of art hence negating the need to offer a concrete definition. There are three established principles that are determinative of whether any received payments are income. First, the determination of whether payment is income must be made according to ordinary concepts and usages of mankind.¹⁷ Second, there must be scrutiny of the explicit facts

⁸ *Income Tax, BAS and Accounting Fundamentals* (CPA Australia Ltd, 2011).

⁹ *Ibid*

¹⁰ *Income Tax Assessment Act 1997* (Cth) 6-1(2).

¹¹ *Income Tax Assessment Act 1997* (Cth) 6-1(3).

¹² *Income Tax Assessment Act 1997* (Cth) 6-1(4).

¹³ *Income Tax Assessment Act 1997* (Cth) 6-1(5).

¹⁴ *Income Tax Assessment Act 1997* (Cth) s 6-5(1).

¹⁵ *Income Tax Assessment Act 1997* (Cth) s 6-5(2).

¹⁶ (1935) 2 ATD 142.

¹⁷ Australian Tax Office Tax Ruling 1999/17 para 16.

and an examination of the character of the payment from the recipient's perspective.¹⁸ Third, the determination must be made in an objective manner.¹⁹

Characteristics of Ordinary Income

Case law has developed various specific preconditions and distinguishing traits as devices that are applied in determining whether proceeds of any transaction qualify as income. Gilders et al, have classified these traits into propositions that have to be considered in their totality while determining whether, on the facts of a particular case, receipts qualify as income.²⁰ The prerequisites are that there must be real profit accruing,²¹ and the profit must be either money or in a form that can be converted into cash.²² Another proposition asserts that capital gains do not qualify as ordinary income.²³ Concerning compensation, whether it qualifies as income depends on its nature. In *Commissioner of Taxes (NSW) v Meeks*,²⁴ the court concluded that compensation adopts the same character of the receipt it replaces. Therefore, if it is for the loss of capital, it is capital in nature, and if it is for the loss of profits or income, it qualifies as income.²⁵ Personal gifts do not qualify as income because they are not earned.²⁶

Further, winnings from gambling and associated windfall profits do not meet the income threshold.²⁷ Another proposition is that income must be derived from an external source. Known as the principle of mutuality, the effect of this proposition is that an individual cannot be the

¹⁸ Ibid; *Stone v Commissioner of Taxes* [2002] FCA 1492, para 59.

¹⁹ Australian Tax Office Tax Ruling 1999/17 para 16.

²⁰ Frank Gilders et al, *Understanding Taxation Law* (LexisNexis Butterworths, 2015).

²¹ *Hochstrasser v Mayes* [1960] AC 376.

²² *FCT v Cooke and Sheridan* (1980) 42 FLR 403; *Federal Coke Co Pty Ltd v FCT* (1977) 7 ATR 515; *Tenant v Smith* (1892) 3 TC 158.

²³ *Eisner v Macomber* (1920) 252 US 189; *Deputy Commissioner of Taxation v DP Smith* (1981) ATC 4414.

²⁴ (1915) 19 CLR 568.

²⁵ *Heavy Minerals Pty Ltd v FCT* (1966) 115 CLR 512.

²⁶ *FCT v Harris* (1980) 10 ATR 869.

²⁷ *Prince v FCT* (1959) 12 ATD 45.

source of their income.²⁸ Only amounts that have come in to the receiver qualify as ordinary income. Following section 6-5 of the *ITAA97*, payment comes into an entity if that entity has derived it. Therefore, payments that have not been realized within the particular financial year do not qualify as ordinary income. In *GP International Pipecoaters v FC of T*²⁹ the court concluded whether a payment has the character of income is determined referring to the person or entity that derives it rather than the character of the expenditure that produced it. Further, the form and frequency of the receipt is determinative of the whether the income character is attained.³⁰ Regular and periodic payments are more likely to be considered as ordinary income as opposed to payments made in a single instance.³¹ However, this is not an essential characteristic.³²

There are three general categories that are recognized as sources of ordinary income. These categories are useful groupings although they are not characteristics of income. These are personal services, property, and business. According to *Hayes v FCT*,³³ any receipt that is as a result of employment or a reward for services that have been offered is accessible income. Where the source of income is personal services, the general proposition is that there must be a sufficient link between the payment and the earning activity.³⁴ In *Moorhouse v Dooland*³⁵ the court's conclusion was that where payment is a direct result of an individual's office, it qualifies as income from personal services. Remuneration for personal services qualifies as income even if it is a one-off payment.³⁶ Further, payment received from an extraordinary transaction that is

²⁸ R W Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (The Law Book Company Limited, 1985).

²⁹ (1990) 170 CLR 124.

³⁰ R W Parsons, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (The Law Book Company Limited, 1985).

³¹ *FCT v Blake* (1984) 15 ATR 1000.

³² *FCT v Myer Emporium Ltd* (1987) 163 CLR 199.

³³ (1956) 96 CLR 47.

³⁴ *Dean v FCT* [1997] ATC 4762.

³⁵ [1955] 1 All ER 93.

³⁶ *Brent v FCT* (1971) 125 CLR 418.

concluded with the intention of making a profit qualifies as ordinary income.³⁷ Further, following *Partridge v Mallandaine*³⁸ the legality of the source of income is an irrelevant factor in the determination of assessable income. It was on this premise that the court in *FCT v La Rosa*³⁹ allowed the defendant to claim deductions comprising money stolen from the proceeds of drug dealing. Therefore, even illegal activities are susceptible to taxation.⁴⁰

Statutory Income

Statutory income comprises receipts that have been made assessable by the express provisions of the Act.⁴¹ For Australia residents, it comprises statutory income from all sources inside or outside Australia.⁴² The Act contains numerous provisions creating statutory income.⁴³ Of relevance is section 15-2 of the *ITAA97* that makes provision for allowances and other things provided concerning employment or services. This provision makes assessable all allowances, gratuities, compensation, benefits, bonuses and premiums accruing from employment or services rendered either directly and indirectly.⁴⁴ The provision applies regardless of their form, money or otherwise.⁴⁵

³⁷ *FCT v Myer Emporium Ltd* (1987) 163 CLR 199.

³⁸ [1886] 2 TC 179.

³⁹ (2003) ATC 4510.

⁴⁰ Ranjana Gupta, 'Taxation of Illegal Activities in New Zealand and Australia' (2008) 3 *Journal of the Australasian Tax Teachers Association*.

⁴¹ *Income Tax Assessment Act 1997* (Cth) 6-10(2).

⁴² *Income Tax Assessment Act 1997* (Cth) 6-10(4).

⁴³ *Income Tax Assessment Act 1997* (Cth) s 15-15; 15-20; Div 20; Divs 82-83.

⁴⁴ *Income Tax Assessment Act 1997* (Cth) 15-2(1).

⁴⁵ *Income Tax Assessment Act 1997* (Cth) 15-2(2).

Deductions

Deductions are expenses that have been incurred in the process of generating assessable income and are claimed to reduce a taxpayer's liability. The *ITAA97* categorizes deductions into general⁴⁶ and specific.⁴⁷ General deductions are losses or outgoings that accrue or that are necessarily incidental to the earning by a taxpayer of assessable income.⁴⁸ The general deductions provision also has an exclusion provision concerning expenses that are capital or capital in nature, private or domestic, incurred in earning exempt or non-assessable non-exempt income or specifically denied by another provision in the Act.⁴⁹ There must be a connection between the claimed deduction and the income generating activity. For this link to be established the expense must be relevant and incidental to the concerned activity and its essential character must be that of an income producing venture.⁵⁰ Specific deductions are those that are premised on any other provision of the *ITAA97*. The sum of the general and specific deductions less any applicable exclusion make up the allowable deductions used to obtain the taxable income.

Application

On the first issue, compensation takes the form of the receipt it replaces. On the facts, Beverly was compensated for alteration of the contract of employment. Therefore, the compensation was in lieu of the loss of income that she would have derived if the law firm would have hired her as planned. Following the rule in *Commissioner of Taxes (NSW) v Meeks*, the compensation qualifies as ordinary income because it replaces the income the Beverly would have received if she had been employed as scheduled. The effect of the payment she received to

⁴⁶ *Income Tax Assessment Act 1997* (Cth) 8-1

⁴⁷ *Income Tax Assessment Act 1997* (Cth) 8-5 and 8-12.

⁴⁸ *Income Tax Assessment Act 1997* (Cth) 8-1(1).

⁴⁹ *Income Tax Assessment Act 1997* (Cth) 8-1(2).

⁵⁰ *W Neville & Co Ltd v FCT* (1937) 56 CLR 290.

sign the restrictive covenant was to limit her right to damages arising from the breach of the original contract of employment. Therefore, it acted to restrict her ability to enforce her rights concerning her loss of income that was occasioned by the breach of the employment contract by the law firm. Accordingly, the payment is in relation to potential ordinary income hence also qualifies as ordinary income.

Payment for acting as a surrogate qualifies as ordinary income because of the following reasons. First, it is contended that the reproductive labor of surrogacy is work.⁵¹ Consequently, surrogacy entails an offer for services. The element of personal exertion is satisfied by the nature of surrogacy procedures. Further, the surrogacy arrangement comprises an unusual transaction. By making reference to Beverly as required by *GP International Pipecoaters v FC of T*, the facts reveal that her intention in accepting the surrogacy arrangement was for the money involved hence for profit. Finally, the fact that surrogacy arrangements are illegal in Australia is irrelevant for taxation purposes. Accordingly, the payment she received in relation to the arrangement qualifies as ordinary income. About the diamond ring, ordinary concepts of income do not include gifts hence they are not assessable income. However, the statutory income provisions of the *ITAA97* concerning allowances and other things provided in relation to employment or services, specifically concerning gratuities, apply. Beverly was given the ring because of the surrogacy arrangement between her and the couple. There is a sufficient connection between the offer of the ring and the services she offered the couple. Consequently, the receipt of the ring qualifies as statutory income.

⁵¹ Bridget J Crawford, 'Taxation, Pregnancy, and Privacy' (2010) 16 *William & Mary Journal of Women and the Law*.

Beverly incurs the power bill costs in the course of her work as a human rights lawyer. This is a profession and qualifies as an activity that generates assessable income. Being a part of her house, only the cost she has apportioned as power consumption costs are considered valid expenses in the course of an income generating activity. Therefore, these costs comprise allowable deductions that she can claim to reduce her tax liability. In the same way, the costs she incurs in defending the suit against her are incidental to her income earning activities, therefore, becoming deductible. She is allowed to claim these expenses in determining her taxable income.

Conclusion

From the foregoing, Beverly's assessable income comprises sums paid as compensation for alteration of the contract of employment, payment for signing the restrictive covenant, payments received as a surrogate and the value of the diamond ring. The costs associated with the office and payments for defending the claim in negligence comprise allowable deductions. Therefore, the difference between the sum of her assessable income and the sum of her allowable deductions makes up her taxable income. The product of this taxable income less any applicable tax offsets results in the amount of income tax that Beverly should pay.

Bibliography

Statutes

Income Tax Assessment Act 1997 (Cth)

Cases

Brent v FCT (1971) 125 CLR 418

Commissioner of Taxes (NSW) v Meeks (1915) 19 CLR 568

Dean v FCT [1997] ATC 4762

Deputy Commissioner of Taxation v DP Smith (1981) ATC 4414

Eisner v Macomber (1920) 252 US 189

FCT v Blake (1984) 15 ATR 1000

FCT v Cooke and Sheridan (1980) 42 FLR 403

FCT v Harris (1980) 10 ATR 869

FCT v La Rosa (2003) ATC 4510

FCT v Myer Emporium Ltd (1987) 163 CLR 199

Federal Coke Co Pty Ltd v FCT (1977) 7 ATR 515

GP International Pipecoaters v FC of T (1990) 170 CLR 124

Hayes v FCT (1956) 96 CLR 47

Heavy Minerals Pty Ltd v FCT (1966) 115 CLR 512

Hochstrasser v Mayes [1960] AC 376

London County Council v Attorney General [1901] 4 TC 293

Moorhouse v Dooland [1955] 1 All ER 93

Partridge v Mallandaine [1886] 2 TC 179

Prince v FCT (1959) 12 ATD 45

Scott v Commissioner of Tax (1935) 2 ATD 142

Stone v Commissioner of Taxes [2002] FCA 1492

Tenant v Smith (1892) 3 TC 158

W Neville & Co Ltd v FCT (1937) 56 CLR 290

Books

Gilders, Frank et al, *Understanding Taxation Law* (LexisNexis Butterworths, 2015)

Income Tax, BAS and Accounting Fundamentals (CPA Australia Ltd, 2011)

Parsons, R W, *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (The Law Book Company Limited, 1985)

Journal Articles

Clark, Braedon, 'The Meaning of Income: The Implications of Stone V FCT' (2004) 14 *Revenue Law Journal*

Crawford, Bridget J, 'Taxation, Pregnancy, and Privacy' (2010) 16 *William & Mary Journal of Women and the Law*

Gupta, Ranjana, 'Taxation of Illegal Activities in New Zealand and Australia' (2008) 3 *Journal of the Australasian Tax Teachers Association*

Subsidiary Legislation

Australian Tax Office Ruling 1999/17