Taxation law essay

1. The assessability or otherwise to Jino and Anna of the annual bonuses paid by Darling Bank to them. Consideration of the proximity of services or employment relationship, the importance of the donor's motive and the status of gratuitous payments are relevant in determining whether the bonuses received are assessable income. We can determine that the bonuses satisfactorily fulfil the requirement that for the bonuses to be assessable they must " come in". (tenant v smith) Natural incidents of employment will be income, because they arise from a service relationship and because they are an expected incident of the occupations. Kelly v DCT) Ultimately, it is the character of the payment in the hands of the recipient that is determinative (Scott) of income. The bonuses received by Jino and Anna were not mere gifts. The amount in Scott v FCT was a gift; it was gratuitous, not made in discharge of an obligation and not taken by the recipient as discharging an obligation and not income by ordinary concepts. The payments in Scott v FCT and Moore v Griffiths were ' one-off'. The payments were in addition to entitlements under service agreements; the donor's motive was to make a personal tribute and the payment was unexpected.

While income generally exhibits recurrence, regularity and periodicity, it would be wrong to conclude they were necessary elements and that a ' one-off' payment in the nature of a ' gift' cannot be income. (demonstrated by Squatting Investment Co) In Moore v Griffiths, the bonus received was a testimonial or personal gift rather than a reward for services rendered by the taxpayer in the course of his employment. The payment had no foreseeable element of recurrence, and there was no knowledge or expectation on the

taxpayer's part that the payment would be made as a reward for rendering his services.

A bonus payment is ordinary income for the purposes of subsection 6-5(2) of the ITAA 1997, which provides that the assessable income of a resident taxpayer includes ordinary income derived directly or indirectly from all sources, whether in or out of Australia, during the income year. The initial presumption, prima facie, a payment from taxpayer to recipient is not income (Hayes v FCT) may be displaced if in substance and reality the payment was a product of services.

Ordinary income is typically regarded as including salary and wages and fees connected with employment or provision of services; the critical element being the connection with an earning activity. Amounts derived from employment or the provision of services are income. In FCT v Dixon, the amount taxpayer received was assessable because the receipts were of an income character, and the amount was an expected periodical payment arising out of circumstances, and also because it formed part of the receipts upon which he depended for regular expenditure.

Similarly, the bonuses Jino and Anna received fulfilled 3 critical elements in FCT v Dixon; the payment was periodical, incidental to employment and relied upon for regular expenditure. In FCT v Harris, payments were unrelated to the length or quality of service, and were periodic yet unpredictable. Hence, they were unassessable as the critical elements in Dixon's case were absent in Harris. In FCT v Kelly, the prize money the

footballer received was held to be payments as income. Kelly was aware that the prize would be offered,

S15-2 sets out that allowances and other things provided in respect of employment or services can be included in your assessable income. S15-2(1) states that " assessable income includes the value to you of all allowances, gratuities, compensation, benefits, bonuses and premiums provided… in respect of… any employment of or services rendered". Hence, if the bonuses are consequently not considered ordinary income, it will still be regarded assessable under s15-2 as the amount that is assessable as ordinary income under s6-5 is not included in assessable income under s15-2(3).

The key issue to consider is the ' connection with earning activity'. It was for ' work throughout the year'. The $100, 000 bonuses can therefore be included in assessable income under s. 15-2 as a reward for personal exertion, even though the bonuses were unexpected and not relied upon by Jino and Anna (Moore). The bonuses were recurring, incidental to employment, of an ordinary kind. (Scott) There is direct nexus with employment; FCT v Cooke & Sherden is irrelevant because the holidays received did not represent income.

There was no entitlement to alternative compensation if the holidays were not taken, and it was also not convertible into money. 2. Whether Jino and Anna are entitled to deductions for interest paid on the amount they redraw from their loan on the Darling Point property to partly finance their investment in the King Street property. ITAA97 S8. 1 (1) provides that you

can deduct from your assessable income any loss or outgoing to the extent that “ it is incurred in gaining or producing your assessable income”.

Hence, Jino and Anna will be entitled to deductions for interest paid on the amount they redraw from their loan “ to the extent” they are using it to finance their investment in the King Street property. Interest is characterised by the use of the funds; the fact that the original loan was for the Darling Point property is irrelevant. Consideration must be given to the redraw facility, that any fund used from the redraw is used to produce assessable income or for the business, and the interest on the portion of the fund will be deductible to that extent.

In FCT v Munro, the deduction for interests were not permitted under s. 8-1 ITAA97. It was held that the “ deductibility of interest depends on the purpose for which the principal is borrowed, a deduction in interest is not permitted when the borrowed money is used for a purpose whereby no income is produced, even if the money is borrowed on the security of rent producing property”. The commissioner disallowed the taxpayer’s claim for deductions, on the basis that the borrowed moneys had not been applied exclusively to produce assessable income.

The borrowed money had been applied for the benefit of the sons and hence interest was not incurred in gaining assessable income. Conversely, the purpose for which the principal amount of $400, 000 Jino and Anna borrowed was for an investment in property that would produce rent. The fact that the Darling Point property was used as security for the loan as it was withdrawn from the ‘ repayment redraw’ facility for residential property is irrelevant.

Hence, Jino and Anna should be entitled to deductions for the 6% interest paid on the $100, 000 withdrawal from the redraw facility.

Steele v FCT considers whether there is sufficient nexus of residence with income production; interest incurred before assessable income is derived is deductible if there is. It was established that the meaning of ‘ assessable income’ in the first limb of s51(1) is summarised in Fletcher & Ors v FCT (1991) 173 CLR. Assessable income is to be “ construed as an abstract phrase which refers not only to assessable income derived in that or in some other tax year but also to assessable income which the relevant outgoing ‘ would be expected to produce’…”.

The 6% interest withdrawn from their loan is incurred before assessable income is derived hence is deductible. 3. Appropriate tax treatment of the lump sum payout to Thomas from both Jino and Anna’s perspective and from Thomas’s perspective From Jino and Anna’s Perspective TR 2005/6 1. This Ruling explains the circumstances where it is considered that: (a) a lease surrender receipt is assessable income under section 6-5 of the Income Tax Assessment Act 1997 (ITAA 1997); and (b) a lease surrender payment is deductible under section 8-1 of the ITAA 1997. . This Ruling also addresses the application of the provisions of the ITAA 1997 covering capital gains and capital losses (CGT). The first issue to consider is first considering the general deduction provision s8-1. Although the lump sum payout passes the 1st positive limb, based on Sun Newspaper Ltd v FCT, we can establish that the payout is not of revenue but of a capital nature. There are 3 matters to consider in determining whether the payout is on revenue or capital account. Footnote: pg 446 of casebook) Parallel to the features of transactions of the

expenditure in Sun Newspaper, [1] (a) the payout was of a large sum intended to remove competition for Tony, (b) the payout was recurrent in the sense that the risk of a competitor arising must always be theoretically present, (c) the chief object of the …… Considering the general deduction provision s8-1, if the payout was revenue, it would be deductible. However, the capital nature of the payout fails the negative non-capital requirement under s8-1.

As Jino and Anna are not " carrying on a business of gaining or producing assessable income" (s8-1(b)) in leasing out the shop, it is still a capital gains tax and we must consider further provisions for specific deductions for capital expenditure. Jino and Anna were not obliged to lease the shop to receive rent because Thomas was already willing and happy to pay fixed rental of $3, 500 per month for 5 years. Therefore, the $5000 is not deductible because it is not a loss, but rather a result of voluntary action. If it were a loss incurred, then the amount would be deductible.

Second, for the lump sum payment to be deductible, the expense has to be related to producing assessable income. Herald and Weekly Times Ltd v FCT derives the notion ' incurred', as " the expenditure (legal fees) incurred by the taxpayer was wholly and exclusively expended in gaining or producing its assessable income and was therefore deductible under s23(1)(a). " Since the $5000 payment was to terminate Thomas's lease and provide an opportunity for Jino and Anna to obtain $500 more in monthly rent, it can be seen as being incurred to gain assessable income from the new lessee Tony.

Consequently, the expense of $5, 000 is deducted by straight line method over five years. Thomas's Perspective The amount paid to Thomas can either be capital in nature where " the lease formed part of the profit-yielding-structure of the lessee's business" or it could be income which " arises in the course of business activity". If the compensation payment lead to the cancellation of business leaving the profit-making structure permanently impaired, then it constitutes as a capital gain. Considering Heavy Minerals (1966) Californian Oil Products

In Van den Bergs Ltd v Clark (1935), the House of Lords held that " the sum received by the taxpayer… on the termination of the arbitration and in consideration of the taxpayer's consent to termination… was a capital receipt and shouldn't be taken into account in computing the taxpayer's liability to tax. " 4. Appropriate tax treatment of the waiver of Tony's first month's rental from both Jino and Anna's perspective and from Tony's perspective Jino and Anna's perspective No money involved – agreement Not meant to pay each other money. Tony didn't pay out any rent and anna didn't receive.

No money exchanged therefore first month no assessable income as no exchange. For tony didn't pay out any rent therefore no deduction Tony's perspective Orica Reduction in expenditure can not be income according to ordinary concepts assessable under s25(1). There was no profit or gain made as a result of the taxpayer entering into arrangements which was ' a singular transaction, not part of the regular means whereby the taxpayer obtained returns'. Lees & Leech Even if it was assumed the payment received by

taxpayer constituted a profit or gain, the payment was not received by it in the ordinary course of carrying on its business.

TR 93/6 1. This Ruling is concerned with those arrangements which are used to reduce the interest payable on a customer's loan account. These are commonly referred to as ' interest offset arrangements' but are called ' loan account offset arrangements' in this Ruling. These products are generally structured so that no interest is derived by the customer and therefore the customer is not liable to pay income tax in respect of the benefit arising from the account. This Ruling: • outlines the manner in which acceptable loan account offset arrangements usually operate; and • xplains the limits on acceptable arrangements. 5. The appropriate tax treatment of the early repayment penalty from both Jino and Anna's perspective and from Tony's perspective TR 93/7 A penalty interest payment is generally deductible under subsection 51(1) if: (a) the loan moneys were borrowed for the purpose of gaining or producing assessable income or for use in a business carried on for that purpose; and (b) the payment is made in order to rid the taxpayer of a recurring obligation to pay interest on the loan, where such interest would itself have been deductible if incurred.

Where the repayment of loan moneys borrowed for the purpose of producing assessable income is secured by mortgage, penalty interest payable on an early repayment which effects a discharge of the mortgage will generally be deductible under section 67A. 5. Penalty interest is not expenditure incurred in borrowing money so as to be deductible under section 67. 6. Where penalty interest is paid upon repayment of a loan incidental to the disposal of an asset, the payment is not taken into account under Part IIIA of the ITAA

in calculating the amount of any capital gain or capital loss arising on the disposal.

Subsection 51(1) provides that: “ all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or are of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income. 9. Generally speaking, provided loan moneys were borrowed for the purpose of gaining or producing assessable income or for use in a business carried on for that purpose, penalty interest payable on early repayment of the loan will, unless it is of a capital nature, qualify for deductibility under subsection 51(1). This will commonly involve borrowings used to acquire an income-producing asset or to provide working capital to operate a business. 10.

In the case of such borrowings, the central issue is whether penalty interest payments are “ losses or outgoings of capital, or of a capital… nature”. If so, then they will not be deductible under subsection 51(1), but may be deductible under sections 67 or 67A. 11. We do not consider that so-called penalty interest is, in fact, in the nature of interest. This is so even if the loan agreement uses the term “ penalty interest”. The description of an item used in any relevant agreement is not conclusive of its character (refer FC of T v. Sth. Aust.

Battery Makers Pty. Ltd. (1978) 140 CLR 645 at 655; 78 ATC 4412 at 4417; 8 ATR 879 at 884 per Gibbs ACJ and Cliffs International Inc. v. FC of T (1979) 142 CLR 140 at 148; 79 ATC 4059 at 4064; 9 ATR 507 at 512 per Barwick CJ). To call a payment “ interest” does not conclusively determine that it in fact answers that description. Nor does it prevent the payment from being an outgoing of a capital nature. 12. Interest is considered to be “ compensation to the lender for being kept out of the use and enjoyment of the principal sum”: see FC of T v.

The Myer Emporium Ltd. (1987) 163 CLR 199 at 218; 87 ATC 4363 at 4371; 18 ATR 693 at 702). Penalty interest is not paid for the use of the lender’s money. It is paid in respect of a period when the borrower has repaid the loan and does not have the use of the money (refer R. W. Parsons, Income Taxation in Australia at para. 6. 330) 13. The critical factor in determining the essential character of an outgoing is the character of the advantage sought by the making of the expenditure (Sun Newspapers Ltd. v. FC of T (1938) 61 CLR 337 at 363 per Dixon J).

Whether an outgoing is capital or revenue in nature “ depends on what the expenditure is calculated to effect from a practical and business point of view” (Hallstroms Pty. Ltd. v. FC of T (1946) 72 CLR 634 at 648 per Dixon J). 14. As a penalty interest payment is a cost directly attributable to obtaining early repayment of a loan, the question to be answered is effectively: “ what, from a practical and business point of view, is the advantage sought from an early repayment of the loan? ” This is a question of fact to be answered on a case by case basis. 5. Where the advantage sought is the release from the contractual obligation to incur a recurrent liability to pay interest on the loan,

and such interest would itself have been deductible, then the penalty interest payment is on revenue account (FC of T v. Marbray Nominees Pty. Ltd. 85 ATC 4750; (1987) 17 ATR 93, Metals Exploration Ltd. v. FC of T 86 ATC 4505; (1987) 17 ATR 786). Such a payment does display certain capital indicia in terms of the tests enunciated by Dixon J. in the Sun Newspapers case (supra); i. e. t is a once-and-for-all type lump sum which eliminates a threatened disadvantage and thus produces a benefit of a lasting character for the taxpayer. Nevertheless, where the initiating cause for early repayment of the loan is a saving in future interest outlays, the payment is essentially revenue in character. 16. On the other hand, where the penalty interest payment is paid effectively as a price to rid the taxpayer of a burdensome capital asset or is otherwise incidental to the realisation of an asset, then it will generally be on capital account. 17.

Where repayment of a loan is secured by mortgage, penalty interest payable on early repayment may be deductible under section 67A. Section 67A provides a deduction for expenditure (excluding principal or interest payments) incurred in connection with the discharge of a mortgage securing repayment of moneys borrowed for the purpose of producing assessable income. Unlike subsection 51(1), deductibility is not affected by whether the expenditure is capital or revenue in nature. As previously discussed, so-called penalty interest is not, in fact, in the nature of interest, and is therefore not excluded on his basis from deductibility under section 67A. 18. Borrowing expenses which are on capital account and for that reason not deductible under subsection 51(1) may qualify for deduction under section 67. However, penalty interest is not “ expenditure incurred… in borrowing

money" for section 67 purposes. These words, in the context of section 67(1), refer to a " cost" of borrowing; i. e. expenditure incurred in relation to the actual establishment of the relevant loan. The liability to pay penalty interest is first incurred after the money is borrowed, and is therefore not incurred in borrowing the money.

The payment is not made pursuant to a contractual obligation which was incurred at the time of borrowing as an incident of establishing the loan (refer Ure v. FC of T 81 ATC 4100; (1981) 11 ATR 484). 19. Where penalty interest is paid upon repayment of a loan incidental to the disposal of an asset, the payment is not taken into account for Part IIIA purposes in calculating the amount of any capital gain or capital loss arising on the disposal. The payment would not be included in the cost base of the asset under section 160ZH.

In particular, it is not within the categories of " incidental costs" of acquisition or disposal in subsections 160ZH(5) or 160ZH(7), and, as it is not in the nature of " interest" (see paragraphs 11 and 12 above), is not a " non-capital cost" under subsection 160ZH(6A). 22. Anne obtains a loan from a financial institution to purchase a rental property. Within the term of the loan Anne decides to sell the property. This requires her to repay the loan in order to discharge a mortgage over the property which secures the loan. In paying out the loan early Anne incurs a penalty interest payment. 3. The repayment of the loan, and the associated incurrence of the penalty payment, is a necessary incident of the sale of the property. A payment so connected to the realisation of a capital asset will be on capital account. The payment is therefore not deductible under subsection 51(1). The payment will, however,

qualify for deductibility under section 67A as expenditure incurred in discharging a mortgage. 6. The CGT effects for Jino and Anna of the sales of the Darling Point apartment and of the King Street Property ————————–