TR 94/D33 - Income tax: capital gains: application of subsections 160M(6) and 160M(7) to restrictive covenants and trade ties

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Draft Taxation Ruling
Income tax: capital gains: application of subsections 160M(6) and 160M(7) to restrictive covenants and trade ties

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TD 93/238

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What this Ruling is about

1. This Ruling is one in a series of Taxation Rulings and Taxation Determinations which will provide interpretations of particular aspects of the operation of subsections 160M(6) and (7) of Part IIIA of the *Income Tax Assessment Act 1936*.

2. This Ruling considers the capital gains tax implications of consideration received for granting restrictive covenants and trade ties and outlines the situation both before and after the amendments to subsections 160M(6) and (7) made by the *Taxation Laws Amendment Act (No.4) 1992* (TLAA (No.4)).

3. This Ruling also explains the implications of the decisions of the Full High Court of Australia in *Hepples v. FC of T* (1991) 173 CLR 492; 91 ATC 4808; (1991) 22 ATR 465 (*Hepples' case*) and of the Federal Court of Australia (Heerey J) in *Paykel v. FC of T* 94 ATC 4176; (1994) 28 ATR 92 (*Paykel's case*) for the treatment of consideration received in respect of restrictive covenants.

4. For the purposes of this Ruling the types of covenants addressed are:

(a) restrictive covenants in the context of employment related contracts, as between employer and employee in the context of a contract of service; and

(b) agreements between a vendor and purchaser for the sale of business by contract where the vendor agrees not to compete in trade; and

(c) exclusive trade ties between two parties with an agreement entered into by a business entity not to trade within a specified geographical region and/or for a period of time, or exclusive dealing contracts tied to a product or to the supply of services.

5. The Ruling does not cover:

(a) in any detail, the possible assessability of consideration received for restrictive covenants under general income tax provisions;

(b) exclusions in section 160MA; and

(c) the possible application of the miscellaneous roll-over provisions in Division 17 of Part IIIA to subsections 160M(6) and (7).

6. For the purposes of this Ruling a restrictive covenant is an agreement between two or more parties to refrain from doing some act or thing. Also, where the word 'received' is used, this includes 'entitled to receive'.

Ruling

Pre 1992 amendments

7. (a) We accept that the former subsection 160M(6) does not apply to a restrictive covenant between an employer and employee.

(b) We accept that the former subsection 160M(7) does not apply to a restrictive covenant between an employer and employee where the facts are on all fours with those in the decisions of *Hepples* and *Paykel* ie., where the restrictive covenant takes effect after termination of employment.

(c) We consider that the former subsection 160M(7) applies where the restrictive covenant takes effect before the termination of employment.

(d) We consider that the former subsection 160M(7) applies to exclusive trade arrangements and also to any agreements not to compete in trade.

(e) Paragraphs 9 to 11 of this Ruling explain the taxation treatment of consideration for granting a restrictive covenant that relates both to a period of current employment and to a period after the end of that employment.

Post 1992 amendments

8. (a) We consider that the new subsection 160M(6) generally applies to any transaction where an amount (whether money or property) is received for entering into any restrictive covenant including an exclusive trade tie and an agreement not to trade.

(b) In the case of restrictive covenants the new subsection 160M(7) has limited operation and applies where an act, transaction or event takes place in relation to an asset owned by the taxpayer. Where all the conditions of subsection 160M(7) apply, the section operates only where subsection 160M(6) does not. An example is a payment to refrain from exercising a right which does not result in other rights vesting in the payer. In exclusive trade arrangements subsection 160M(7), in practice, only rarely applies.

(c) Paragraphs 9 to 11 of this Ruling explain the taxation treatment of consideration for granting a restrictive covenant that relates both to a period of current employment and to a period after the end of that employment.

Covenants relating both to current employment and afterwards

9. We consider that if a restrictive covenant relates both to a current period of employment and to a period after the end of that employment, the portion of the consideration received that relates to the period of employment is assessable under subsection 25(1) or paragraph 26(e). That portion would also come within either the old subsection 160M(7) or the new subsection 160M(6) (with the new subsection 160M(7) as a backup) depending on whether the restrictive covenant was entered into before 26 June 1992 or on or after that date. This assumes there is an existing asset at the time of entry into the covenant - eg trade secrets, trade connections or goodwill of value. Subsection 160ZA(4) would apply to reduce any capital gain to the extent that the amount was assessable as ordinary income.

10. The portion of the consideration that relates to the period after the end of the employment is assessable under the new subsection 160M(6). Neither the old subsection 160M(6) nor the old subsection 160M(7) applies to that portion of the consideration. This means that if the restrictive covenant was granted before 26 June 1992, that portion of the consideration is not subject to Part IIIA.

11. If the contract does not apportion the payment and it is not possible to make any reasonable apportionment, the whole amount is

assessable under the old subsection 160M(7) if the restrictive covenant was entered into before 26 June 1992 or under the new subsection 160M(6) if the restrictive covenant was entered into on or after that date.

Our view of the *Hepples* and *Paykel* cases

12. In our opinion, the decision of the High Court in *Hepples* applies only to those agreements between employers and employees that were entered before 26 June 1992 (the date from which the relevant amendments made by the TLAA (No.4) apply).

13. The former subsection 160M(6) was interpreted by the Full Court of the Federal Court of Australia in *Hepples* to apply only where assets are created out of or over existing assets (the 'carving out' approach). In *Reuter v. FC of T* 93 ATC 4037 at 4051; (1993) 24 ATR 527 at 545 Hill J found that in *Hepples* the judgment of McHugh J (with which Mason CJ agreed) represented the majority view of the High Court in respect of subsection 160M(6) being limited to the 'carving out' approach. We therefore accept that the former subsection 160M(6) applies only to assets created out of or over an existing asset. Accordingly, this subsection does not apply to restrictive covenants because there is no existing asset out of which the new covenant and rights are carved or created.

14. We do not consider the *Paykel* decision to be authority for the view that the former subsection 160M(7) applies only in relation to an asset owned by the taxpayer.

Other issues

15. On the grant of a restrictive covenant it is not the underlying asset, namely the goodwill, which is disposed of, but a notional (or fictional) asset that arises by operation of subsection 160M(7). Thus, the concessional treatment afforded by section 160ZZR to the disposal of goodwill, for example under an agreement to sell a business, is not available in respect of the disposal of the notional asset.

16. In our view a restrictive covenant that protects goodwill still has value in its own right and it is necessary to apportion the consideration received between goodwill and the restrictive covenant.

17. We consider that the purpose and effect of subsection 160M(7) extends to recognise as consideration the benefit of mutual promises flowing to the parties, even if those promises are not in themselves property. The benefit must be measurable. However, under the provisions of subsection 160M(6) a capital gain only arises where an amount of money or property is received for creating an asset.

18. In our opinion subsection 160M(7) applies at the time of entering into the covenant rather than when consideration is received.

19. It is immaterial whether the underlying asset for the purposes of subsection 160M(7) was acquired before 20 September 1985 or on or after that date. The relevant asset that is deemed to be disposed of for the purposes of subsection 160M(7) is the notional asset and not the underlying asset to which it relates.

20. A non-resident who receives consideration under a restrictive covenant before the 1992 amendments is not subject to the capital gains tax provisions. This is because we now consider that there is no disposal of a taxable Australian asset in terms of section 160T. After the 1992 amendments, paragraphs 160T(1)(l) and (m) provide that such a notional asset is deemed to be a taxable Australian asset and subject to tax on any capital gain.

21. It is the act, transaction or event which most directly relates to the consideration received which is the subject of subsection 160M(7).

Date of effect

22. Subject to the exception mentioned in paragraph 23 below, this Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

23. Paragraph 17 of this Ruling states the view that 'consideration' for the purposes of subsection 160M(7) is not limited to money or property. Rather, 'consideration' extends to measurable mutual promises flowing to the parties, even if those promises are not in themselves property. This interpretation is less favourable to taxpayers than our earlier view that 'consideration' was limited to money or property. Our earlier view appears in the minutes of the meeting of the Capital Gains Tax Subcommittee of the Taxation Liaison Group that was held on 2 June 1993. The broader view taken in this Ruling applies only to consideration other than money or property that is given after the date of this Ruling (in its final form).

Explanations

General law

24. Restrictive covenants may at general law amount to being a covenant in restraint of trade. In the leading House of Lords decision *Esso Petroleum Co. Ltd v. Harper's Garage (Stourport) Ltd* [1968] AC 269 (at 298) Lord Reid said that a 'restraint of trade' implies that a person has contracted 'to give up some freedom which otherwise he would have had': (approved and followed in Australia by the High Court in *Amoco Australia Pty Limited v. Rocca Bros Motor Engineering Co. Pty Ltd* (1973) 133 CLR 288).

25. Examples of restrictive covenants include:

(a) covenants between employers and employee:

such as to refrain from doing some act (for example, a promise not to disclose special processes, trade connections and trade secrets of the employer). A restrictive (negative) covenant may include the prevention of the employee from competing in another business or opening a new business, including a restriction on competition enforced by a separate agreement which comes into effect after cessation of employment. In addition, a contract of employment may stipulate exclusive service by the employee during its term. This by its nature restricts personal freedom.

(b) covenants given by sub-contractors, professionals and individuals such as sportspersons etc:

such as a covenant given by an entertainer exclusively to endorse products or services.

Employment related covenants

26. As to the characterisation of employment related covenants, and payments made pursuant to a contract of service, Mitchell J in *FC of T v. Woite* 82 ATC 4578; (1982) 13 ATR 579 (*Woite's case*) referred to the decision of the English Court of Appeal, in *Jarrold v. Boustead* (1964) 3 All ER 76 (*Jarrold's case*).

27. In *Jarrold* the capital amount received was for giving up an amateur status for life, whereas in *Woite* the amount was for depriving the player of an opportunity which would otherwise have been open to him. The case of *Woite* was a decision cited with approval by Heerey J in *Paykel* with the observation that had the payment been followed

by a contract for services then the character of the restrictive covenant may have changed.

Business trade ties and agreements not to compete in trade

28. A restraint of trade that is valid at common law which is not held to be an unreasonable restraint by the courts requires that the covenantee is entitled to protect an interest. This will usually be an interest in property, typically the goodwill of a business (see *Bacchus Marsh Concentrated Milk Co. Ltd (in liquidation) and another v. Joseph Nathan & Co. Ltd* (1919) 26 CLR 410 at 438).

29. Examples of trade ties and exclusive agreements include:

(a) agreements not to compete:

such as a restriction on competition where the entire payment under the covenant is the non competition monetary value and no amount is attributable to goodwill for the sale of a business;

(b) business trade ties:

such as an agreement to take supplies of a product exclusively from a particular supplier for a particular period; or to sell a specific product exclusively from particular premises.

30. Trade ties may contain two aspects, both negative and positive. Kitto J in *BP Australia Limited v. FC of T* (1964) 110 CLR 387; (1964) 13 ATD 268) stated at CLR 412 - 413; ATD 274:

> '... a promise by a service station operator not to deal with oil companies other than the appellant or its allies was only the negative side of the substantial positive advantage which ... was the purpose and practical effect of the agreement to produce, namely the advantage of a practical certainty that the whole of the custom of the service station, for motor spirit, would be given to the appellant or its allies for the agreed period; and what the appellant really paid its money for was that positive advantage'.

It is a question of fact whether the payment is received for the one restrictive covenant or for separate positive and negative covenants, where at least part of the payment may represent assessable income

31. In the case of a restrictive covenant the most relevant asset is likely to be goodwill of the payer for the purposes of the former subsection 160M(7). In these circumstances the covenant is analogous to a fence surrounding and protecting the goodwill. Following the 1992 amendments, subsection 160M(6) applies to restrictive covenants and it is no longer necessary to identify the most relevant underlying asset.

32. This principle is demonstrated by the case of *Box v. FC of T* (1952) 86 CLR 387; (1952) 10 ATD 71. In that case an initial question was whether or not the consideration for the restrictive covenant was for, or connected with, the acquisition of the goodwill of the business. Dixon CJ, and Williams, Fullagar and Kitto JJ in a joint judgment held that it was connected with the acquisition of the goodwill of the business:

> 'The [payment] was paid as consideration for the vendor entering into the restrictive covenant. It was not paid directly for the purchase of the goodwill. ...[The consideration for the covenant] was paid to protect and enhance the value of [the] business so that the purchaser would be able to carry it on in the future in the same profitable manner as the vendor had previously carried it on without the risk of the vendor commencing or becoming engaged in a competing business' (at CLR 394, 397; ATD 73, 74).

Although the covenant protects the value of goodwill it has value in its own right.

33. A contract for the sale of a business, such as one operated under a statutory licence, may allocate consideration to the different assets which are the subject of the conveyance, including for example, the transfer of land, goodwill (inherent in the licence) and the value of restrictive covenants given by the vendor not to compete in a similar business. The apportionment may be subject to scrutiny by the courts to determine whether the apportionment is properly done so as to represent accurately amounts that apply to the goodwill, and the value of the covenant in so far as it relates to the goodwill of the vendor's business: *Eastern National Omnibus Co. Ltd v. IRC* (1938) 3 All ER 526. See also *Mordecai v. Mordecai* (1988) 2 NSWLR 58.

Application of subsection 160M(6)

Pre 1992 amendments

An asset in terms of subsection 160M(6)

34. The former subsection 160M(6) provided that a disposal of an asset that did not exist (either by itself or as part of another asset) before the disposal, but is created by the disposal, constitutes a disposal of the asset by the person who disposed of the asset. The person who disposed of the asset is deemed not to have paid or given any consideration or incurred any incidental costs or expenditure other than the amount of the non-deductible incidental costs of the disposal of the asset.

35. The 'carving out' approach referred to in paragraph 13 of this Ruling implies that the underlying asset from which another asset is carved out must exist before the carving out.

36. In the High Court case of *Hepples*, Toohey J agreed with Mason CJ and Deane and McHugh JJ that subsection 160M(6) did not apply because there must be an asset which is created and disposed of. He states that 'it is necessary to identify something the taxpayer owned or something that the taxpayer did in the capacity of owner which is the subject of disposal': (91 ATC at 4827; 22 ATR at 487). The mere agreement not to exercise personal rights otherwise available to him is not sufficient to attract subsection 160M(6): (91 ATC at 4828; 22 ATR at 488). Thus, subsection 160M(6) was held not to apply.

37. Accordingly we accept that the former subsection 160M(6) does not apply to payments made under restrictive covenants.

Post 1992 amendments

38. The expanded definition of 'asset' in subsection 160A extends to created personal rights, since they would be 'any other right whether or not legal or equitable and whether or not a form of property'. Goodwill or any other form of incorporeal property is specifically included. The explanatory memorandum to the Bill that later became TLAA (No.4) states at page 65 that :

> 'To be an asset, a right must be recognised and protected by law - a court of law or equity will assist in enforcing it. Personal liberties and freedoms, such as the freedom to work or trade or to play amateur sport, are not legal or equitable rights and accordingly will not be assets for CGT purposes. [But this does not mean that money or other consideration received in relation to personal liberties and freedoms cannot be taxed under the CGT provisions...]'.

39. In the context of the giving of a restrictive covenant, an asset is created and vested in another person as described in paragraphs 160M(6)(a) and (b). That asset is the contractual right brought into existence by the entering into the contract, or deed. If the facts in *Hepples* applied after 25 June 1992, Mr Hepples would have created the right to enforce the restrictive covenant and would have acquired it immediately before disposing of it to his employer. The employer would have received the benefit of that chose in action which would have vested in the employer upon the signing of the agreement or deed by the parties. The effect of the covenant would be to protect the goodwill of the employer and the benefit of the covenant would enhance the goodwill of the employer and become part of that goodwill.

New subsections 160M(6) - 160M(6D)

40. The new subsections 160M(6) -(6D) apply to an asset which is created by a person where:

- that asset is not a form of corporeal property; and
- on the creation of the asset it is *vested* in another person.

41. The new subsection 160M(6) operates only if the other provisions of Part IIIA (excluding subsection 160M(7)) do not apply.

42. The effect of subsections 160M(6)-(6D) in relation to a restrictive covenant is that the person who receives the payment creates certain rights on entering into the covenant. Those rights comprise an asset that is not a form of corporeal property and which, on its creation, vests in the payer. The recipient of the payment is taken to have acquired, and to have commenced to own, the asset immediately before the time of the making of the covenant (paragraph 160M(6A)(a) and subparagraph 160U(6)(a)(ii)). The recipient is then taken to have disposed of the asset to the payer at the time of the making of the covenant (paragraph 160M(6A)(b) and subparagraph 160U(6)(a)(iii)). The consideration for the disposal of the asset is the amount received for granting the restrictive covenant.

43. The person creating the asset is taken not to have paid or given any consideration, or incurred any costs or expenditure other than non-deductible expenditure incurred incidental to the disposal: paragraph 160M(6A)(c) and subsection 160ZH(6).

44. Paragraph 160ZD(2)(a) does not apply to deem any market value consideration to have been received by the person creating the asset where there is no form of consideration received: paragraph 160M(6A)(d). The explanatory memorandum states at page 58:

> 'This will ensure that the person who creates the asset will only have a capital gain if he or she actually receives as consideration an amount of money or property for creating that asset'.

45. The word 'vested' as used in subsection 160M(6) is described in the explanatory memorandum as having:

> '...the broader meaning of the person being placed in possession or control of the asset. The use of this broader meaning is dictated by the fact that "asset" will now include rights which are not forms of property'.

Application of subsection 160M(7)

The underlying asset in subsection 160M(7)

46. In *Hepples,* the Full Federal Court (90 ATC 4497; (1990) 21 ATR 42) and the High Court considered the application of subsections 160M(6) and(7) to the payment from an employer to an employee under a restrictive covenant.

47. Their Honours in the Full Federal Court and the High Court identified a number of possible assets including:

(a) goodwill of the employer. All the judges of the High Court (except Gaudron J) regarded the relevant asset as being the goodwill of the employer.

(b) the right of the employer under the existing employment contract (per Gummow J - 90 ATC at 4519 - 4520; 21 ATR at 69); compare with Gaudron J in the High Court at 173 CLR 528; 91 ATC 4828; 22 ATR 488 where she speaks of the right of the employer and its associated companies to enforce the promise of the appellant as the relevant asset for subsection 160A).

(c) trade secrets.

48. It will generally be the case that the entering into covenants being business trade ties and agreements not to compete, including covenants such as the grant of a right to market a particular product, will be acts, transactions or events affecting the goodwill of the business, provided the nexus requirement is met.

49. Based on the facts of each individual case there will generally be underlying assets other than goodwill which will be also be the subject of a contract for the disposal of a business. For example, the shares in the *Paykel* case were argued to be subject assets in respect to which the lump sum payment might be apportioned. See also the English Court of Appeal decision in *Kirby v. Thorn EMI* [1987] BTC 462; (1987) 60 TC 519; [1987] STC 621; [1988] 2 All ER 947. Also in the case of *Tuite v. Exelby* 93 ATC 4293; (1992) 25 ATR 81 the plaintiffs were entitled to damages for the reduction in the capital value of their shares. However, it is immaterial whether the underlying asset was acquired before 20 September 1985 or on or after that date.

50. The majority of the High Court in *Hepples* (Mason CJ, Deane, Brennan and McHugh JJ) held that subsection 160M(7) did not apply to the receipt of consideration for the restrictive covenant. Their Honours determined that there must be an existing asset, and the relevant act, transaction or event must have taken place, in the words of the section, 'in relation to', or have 'affected' that existing asset: (see McHugh J 173 CLR at 544; 91 ATC at 4838; 22 ATR at 501).

51. On the question of whether the asset needs to be owned by the taxpayer, Heerey J found in *Paykel* that the reasoning of Deane J in the High Court decision in *Hepples* was persuasive on the point that the asset must be an asset of the taxpayer. His Honour also referred to Hill J's dissent in that case in the Full Federal Court and his discussion of the issue in *FC of T v. Cooling* 90 ATC 4472; (1990) 21 ATR 13 at ATC 4491-4494; ATR 34-38. However, we respectfully consider that there is greater judicial support for the contrary view to be found in the *Hepples'* judgments.

52. Of the judgments of the Full High Court, only Deane J expressed the view that the asset must be an asset of the taxpayer. McHugh J agreed with the views of the majority of the Full Federal Court on the point (Gummow and Lockhart JJ, Hill J dissenting) that the asset need not be an asset of the taxpayer. Brennan J (with whom Mason CJ agreed) declined to express a view on the question. All other members of the Full High Court (Dawson, Gaudron and Toohey JJ) held that the asset need not be an asset of the taxpayer.

53. Accordingly we consider that the former subsection 160M(7) does not require the asset to be owned by the taxpayer. This contrasts with the requirements of the new subsection 160M(7) that the underlying asset be owned by the taxpayer.

54. McHugh J in *Hepples* states that the concluding words of paragraph 160M(7)(b) show that paragraph is not concerned with the actual or deemed disposal of an existing asset; it deems a relevant act or transaction in relation to, or an event affecting, an existing asset to be the disposal of a notional asset: (91 ATC at 4834; 22 ATR at 495).

55. The asset which is disposed of by the operation of subsection 160M(7) was considered by Hill J in *Cooling's case* who stated (at 90 ATC 4473; 21 ATR at 36):

> '...the *consequence* of the operation of the subsection is to constitute or deem there to be a disposal of an asset created by the disposal. The effect of that deeming would seem to be that the "asset" created by the disposal is not an actual asset (and in particular is not the asset referred to in para. (a) of the subsection) but a fictitious asset' (emphasis added).

The nexus requirement

The act, transaction or event must affect an existing asset

56. For subsection 160M(7) to apply, either an act or transaction must have taken place in relation to an asset, or an event 'affecting' as asset must have occurred. There must therefore be a nexus between the act, transaction or event giving rise to the receipt of money or other

consideration and a pre-existing asset. In *Hepples' case*, the relevant act, transaction or event was Mr Hepples' entry into the deed. Their Honours then considered whether the act, transaction or event affected the asset. Of those judges who commented on this point, the court was evenly divided.

57. The application of subsection 160M(7) to restrictive covenants was more recently considered in *Paykel* where Heerey J held on the basis of the *Hepples* decision that subsection 160M(7) did not apply to a payment under a restrictive covenant between an employer and employee for the employee not to compete after the termination of his or her employment.

58. Even though the distinguishing feature of *Paykel's* case was the proximity between the covenant and the termination of employment. Heerey J found that (at 94 ATC 4183; 28 ATR 100):

> 'In my opinion *Hepples* stands for the proposition that a payment by an employer to an employee in consideration of the employee's covenant not to compete after the termination of his or her employment is not within s. 160M(7). That is "the judgment itself", to use the expression of Viscount Dunedin [in *Great Western Railway Company v. Owners of SS Mostyn* [1927] AC 57 at 73]. The present case is on all fours with that judgment'.

59. We accept that the former subsection 160M(7) does not apply to a restrictive covenant between an employer and an employee where the covenant takes effect after the termination of employment. However, we consider that the former subsection 160M(7) applies where the restrictive covenant takes effect before the termination of employment.

Ownership and effect on the asset

60. Where money or other consideration is paid or given under a covenant which affects existing goodwill of a business, the former subsection 160M(7) will be satisfied. The decision of the Federal Court in *Paykel* acknowledges the importance of the nexus requirement.

61. The event had to *affect* the asset and in *Hepples* McHugh J (with whom Mason CJ agreed) said that it was a requirement that the event produce some *effect* or change in the asset. McHugh J stated (91 ATC at 4836; 22 ATR at 497-498):

> 'The starting point in any analysis of an act, transaction or event alleged to be within section 160M(7) is to identify whether the act, transaction or event is one by reason of which "an amount of

money or other consideration" has been paid. The phrase "by reason of" requires that the act, transaction or event upon which the Commissioner relies be the cause of the receipt of or entitlement to the amount of money or other consideration. This means that the act, transaction or event must be precisely identified....Section 160M(7) also requires that the identified act or transaction shall have "taken place in relation to an asset" or that the identified event shall have been one "affecting an asset". The phrase "in relation to" can be of wide import, but in para. (a) the association of that phrase with the words "has taken place" show that "a coincidental or mere connexion" is not enough; there must be a direct connection between the act or transaction which has taken place and the "asset"; cf. *O'Grady v. Northern Queensland Co. Ltd* (1990) 169 CLR 356, at pp. 367, 374. The words "an event affecting an asset" also require an event which produces some effect on or change in the asset...'.

Cases to which the former subsection 160M(7) applies

62. Therefore, in the case of a restrictive covenant, the major question to be determined is whether the act, transaction or event presently affects an existing asset. Examples where subsection 160M(7) will generally apply include:

(a) entering into an exclusive trade tie agreement where the relevant asset may be:

- the goodwill of the supplier, which is immediately enhanced by the guaranteed supply through the outlet; or
- the goodwill of the retailer, because the goods to be sold have a well-known trade name and will bring in custom; and

(b) agreeing not to exercise a right, such as a right to market one product in a certain area;

and in relation to both (a) and (b) an amount of money or other consideration is received or receivable by reason of the act, transaction or event (namely, the entering into of the agreement).

Post 1992 amendments

Explanatory memorandum - intended application

63. Subsection 160M(7) has now been amended to lessen the required nexus between the act, transaction or event and the asset. Paragraph 160M(7)(a) provides that the effect may be beneficial,

adverse or neither. The most significant change is that the relevant asset must now be owned by the taxpayer who received the consideration: paragraph 160M(7)(b).

64. Subsection 160M(7) does not have as broad a scope as formerly applied since, as the explanatory memorandum states, at pp 73 to 74:

> 'Subsection 160M(7) will have a residual application where the other CGT provisions, including the new provisions dealing with the creation of incorporeal assets, have not applied to a transaction. ... This will mean that subsection 160M(7) will only apply where the receipt of an amount of money or other consideration is not in respect of the disposal of an asset or the creation of an incorporeal asset.
>
> Subsection 160M(7) will generally apply as it does at the moment. However, because most payments originally sought to be taxed under subsection 160M(7) will now fall within the new subsection 160M(6), it will apply in fewer cases'.

65. An example of a situation where subsection 160M(7) would in our view continue to apply is if a payment or consideration is given to the owner of an asset and the owner refrains from exercising a right in relation to the asset, or allows the asset to be exploited. This would be the case only if no other provision in Part IIIA applies (eg., subsection 160M(3) or (6)).

The relevant act, transaction or event

66. For subsection 160M(7) to apply, the owner of the asset must have received money or other consideration 'by reason of' the act, transaction or event. According to the *Macquarie Dictionary* the expression 'by reason of' means 'on account of, because of'. It is the act, transaction or event which most directly relates to the consideration received which is the subject of the subsection.

67. It may be necessary to determine the proximate act, transaction or event out of a series of acts or events. For example in the decision of the Full Federal Court in *Naval, Military and Airforce Club of South Australia v. FC of T* 94 ATC 4310; (1994) 28 ATR 161, Jenkinson J found that the relevant transaction consisted of 'the making of the agreement (for transfer of rights over airspace), the execution of a deed and the entry of a memorial on the certificate of title'. Alternatively French J preferred to look at the later registration of the agreement as the relevant event affecting the asset for the purposes of subsection 160M(7). It was in his view, by reason of this event that an amount of money was received. Von Doussa J in dissent did not comment on this point.

68. If there are a number of acts, transactions or events, it is sufficient that any one could be identified as the most proximate causal act, transaction or event.

69. Generally in the case of a restrictive covenant or trade tie, the most relevant act, transaction or event is the making of the covenant or trade tie agreement.

Timing issues

70. The crucial time when the notional asset under subsection 160M(7) is deemed to have been created and disposed of is, in our view, the time of the act, transaction or event affecting the existing underlying asset. In the case of restrictive covenants, it is the date of the entry into the covenant. The amount received is included in the taxpayer's assessable income in the year of income in which the disposal of the notional asset occurs (ie., at the time of the act, transaction or event).

71. The timing for CGT purposes is not when the consideration is received but the time of entering into the covenant. For example if Mr X grants a restrictive covenant on 30 June 1990, resigns from employment on 1 July 1991 and payment occurs on 2 July 1991, the disposal occurs in the year ended 30 June 1990.

72. When an asset is disposed of under a contract, subsection 160U(3) operates to fix the *time* of disposal. Subsection 160U(3) only acts to determine the timing of a disposal under a contract and it does not have a substantive operation. This view is supported by the AAT decision of Dr P. Gerber (Deputy President) in *Case 24/94* 94 ATC 239; C*ase 9451* (1994) 28 ATR 1108 (at ATC 248; ATR 1119):

> '.. it should be kept in mind that subsection 160U(3) does not deem the *disposal* of the relevant asset, but states that the time of disposal (or acquisition) of the relevant asset shall be taken to have been the time of the making of the contract under which that asset was disposed (or acquired)'.

73. However, subsection 160M(7) operates by its own force so that the disposal of the notional asset occurs by virtue of an act, transaction or event which may or may not be under a contract. Therefore neither of subsection 160U(3) nor (4) applies.

Consideration

74. Both before and after the 1992 amendments, paragraph 160M(7)(b) requires that a person has received, or is entitled to receive 'an amount of money or other consideration by reason of the act, transaction or event...'.

75. Subsection 160M(7) is intended to apply to certain capital payments not received in respect of the disposal of an asset. That is, it seeks to tax flows received or receivable upon the happening of an event affecting an underlying asset.

76. The 'catch-all' nature of this provision of last resort is reflected in the term 'money or other consideration' which is arguably wider than the terms 'money' or 'property other than money' as they appear in section 160ZD. This broad scope is supported by the context of subsection 160M(7) and its place in the scheme of the Act.

77. The term 'consideration' has a well-settled meaning in the law of contract and we consider that this meaning is carried into subsection 160M(7). Hill J in his dissenting judgment in *FC of T v. Cooling* 90 ATC 4472 at 4492; (1990) 21 ATR 13 at 35-36 states that:

> 'The use of the word "consideration" suggests that there will be some contractual relationship between the recipient and some other person giving rise to a receipt or entitlement to receive that consideration, be it a monetary consideration or otherwise'.

78. Consideration in the law of contract has been expressed in relation to an enforceable contract as requiring the element of valuable 'consideration'. This can extend to any benefit received by one party or detriment suffered by the other party. Carter and Harland in *Contract Law in Australia* (2nd ed., 1991, Butterworths) suggest the following definition of consideration:

> '...some act or forbearance involving legal detriment to the promisee, or the promise of such an act or forbearance, furnished by the promisee as the agreed price of the promise'.

We consider that the purpose and effect of subsections 160M(7) extends to recognise as consideration the benefit of mutual promises flowing to the parties, even if those promises are not in themselves property.

79. This concept is illustrated by Walsh J in *Amoco Australia Pty Ltd v. Rocca Bros Motor Engineering Co. Pty Ltd* (1973) 133 CLR 288 at 306 where his Honour said that the benefits to be taken into account are 'not limited' to what the covenantor 'receives in money or other property'. His Honour went on to explain, in the context of an exclusive dealing contract, that a covenantor may be regarded as 'obtaining, in return for a restraint, a benefit which consists simply in being able by this means to procure an agreement in aid of his trading'. He gave as an example, an agreement for the regular supply of goods which the covenantor would not be able to obtain but for an agreement to sell only those goods supplied by the covenantee.

80. We consider that there must be a measurable benefit received by the person who enters into the restrictive covenant. In *Mordecai v.*

Mordecai (1988) 2 NSWLR 58 at 64-65, the court rejected an argument that the goodwill of a business was valueless because the business could not be sold on the open market without the two directors entering into restrictive trading covenants which they could not be compelled to give. It was held that the market value of the goodwill was to be determined on the basis that a hypothetical vendor and purchaser would buy on reasonable terms which would require the giving of such covenants, or that the goodwill should be valued on the basis of a hypothetical sale to the directors themselves where such covenants would be unnecessary.

81. An example of a measurable benefit is the undertaking of some liability in return for the assignment of a right to receive future income. A further example from case law in this area is *Wyatt v. Kreglinger* [1933] 1 KB 793 where there was a promise to pay pension benefits, provided the other party did not enter a particular trade.

82. Alternatively it has been suggested that consideration for the purposes of subsection 160M(7) is confined to money or property and it does not extend to 'other consideration', such as an exchange of promises that are not themselves property. However, we do not agree with this view.

83. If no consideration is received for creating the asset, subsection 160M(7) does not apply. Market value consideration is not substituted; that is, paragraph 160ZD(2)(a) does not apply (see Taxation Determination TD 93/238). Consideration in terms of subsection 160ZD(2) is limited to money or property. However, subsection 160ZD(4) may apply where the consideration relates to more than one asset, so that such consideration as may reasonably be attributed to the disposal of the asset shall be taken to relate to the disposal of that asset. In determining an amount which is reasonable in the circumstances, we would have regard to whether the parties were dealing at arm's length.

Non-residents

84. Part IIIA only applies to non-residents to the extent to which they dispose of taxable Australian assets: subsection 160L(2).

85. Before the 1992 amendments it was suggested that subsection 160M(7) will not apply where the taxpayer is a non-resident because the notional asset is not a taxable Australian asset within the categories listed in section 160T. The 1992 explanatory memorandum states that it was intended that a non-resident be taxed on disposal of a fictional asset. It is doubtful that this later expression of intention can be given any retrospective interpretation. It is not permissible to read

a statement made at a later point of time (when the legislation was being amended) in order to discern the intention of the legislature when the original statute was passed: *FC of T v. Bill Wissler (Agencies)* 85 ATC 4626; (1985) 16 ATR 952 per Williams J at ATC 4631; ATR at 957.

86. Restrictive covenants entered into by non-residents after the 1992 amendments are specifically subject to tax under paragraph 160T(1)(l).

87. Accordingly we now accept that the former subsection 160M(7) does not apply to non-residents.

Examples

Example 1

88. Ben intends to build and operate a hotel on the north coast. Bill operates a resort in the same area. Bill does not want Ben to compete with him. Ben enters into an agreement that, for the next 5 years, he will not own or operate a hotel, motel, resort or similar facility within 100 kilometres of Bill's resort. As consideration for that undertaking, Bill pays Ben $100 000.

Pre 1992 amendments

89. The former subsection 160M(6) does not apply because there has been no carving out from an existing asset. The goodwill of Bill's resort is a relevant asset for the purpose of the former subsection 160M(7). It is beneficially affected immediately due to the absence of Ben's competition and so subsection 160M(7) brings the amount to tax.

Post 1992 Amendments

90. Subsection 160M(6) applies as Ben creates contractual rights which are vested in Bill. This prevents Ben from operating within 100 kilometres from the resort owned by Bill. Subsection 160M(7) does not operate because subsection 160M(6) applies.

Example 2

91. Edwina owns the exclusive rights to market a widget in Western Australia. Peter wishes to market a gadget in Western Australia. The gadget performs a similar function to the widget. Peter believes he can establish the gadget in the market place within 5 years. Peter pays

$200 000 to Edwina in return for her not exercising her rights, which she continues to own, to market the widget in Western Australia for a period of 5 years.

Pre 1992 Amendments

92. As there has not been a carving out from an existing asset, the former subsection 160M(6) does not apply. Edwina's exclusive rights to market the widget are a relevant asset for the purpose of the former subsection 160M(7). It falls within the terms of subparagraph 160M(7)(b)(i).

Post 1992 Amendments

93. The agreement prevents Edwina from marketing widgets in Western Australia. It results in incorporeal property which has been created by Edwina and vested in Peter. Accordingly, subsection 160M(6) applies.

Example 3

94. Penelope enters into an employment contract with her employer Tracey Bros. The terms of the contract require her to remain with her employer for three years to develop certain trade secrets and on termination of the contract Penelope is prevented from entering into competition with Tracey Bros for a further two years. In consideration for entering into the contract Penelope receives consideration of $500 000; the contract states that $200 000 relates to the current period of employment and $300 000 relates to the period after employment.

Pre 1992 amendments

95. The consideration is received both in relation to the current employment period and the restrictive covenant which is to apply in three years time. That portion of the payment which relates to the current period of employment ($200 000) is assessable under subsection 25(1) or paragraph 26(e). That portion would also be assessable under the old subsection 160M(7). (However, subsection 160ZA(4) would apply to reduce the capital gain to the extent to which the amount was assessable as ordinary income.) The balance of the payment ($300 000) is not subject to Part IIIA.

Post 1992 amendments

96. That portion of the payment which relates to employment is assessable under subsection 25(1) as that term of the contract comes into effect immediately. The portion relating to the period following the employment would be assessable as a capital gain under subsection 160M(6) (with subsection 160M(7) as a backup).

Note: If the contract did not apportion the payment and it is not possible to make any reasonable apportionment, the whole amount would be assessable under subsection 160M(6) (where a post 1992 arrangement) or subsection 160M(7) (where a pre 1992 arrangement).

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