


TD 2007/D21 - Income tax: are amounts mistakenly paid as salary or wages to employees (or as income support payments or worker's compensation amounts to persons), to which they are not beneficially entitled, but are obliged to repay, 'ordinary income' under section 6-5 of the Income Tax Assessment Act 1997?

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This document has been finalised by TD 2008/9.



Draft Taxation Determination

Income tax: are amounts mistakenly paid as salary or wages to employees (or as income support payments or worker's compensation amounts to persons), to which they are not beneficially entitled, but are obliged to repay, 'ordinary income' under section 6-5 of the *Income Tax Assessment Act 1997*?

❶ This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. No. Amounts mistakenly paid as salary or wages to employees, (or as income support payments or worker's compensation amounts to persons), to which they are not beneficially entitled, but are obliged to repay, are not derived by these persons as income according to ordinary concepts. Accordingly, such mistakenly paid amounts are not assessable income of these persons under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997).¹

¹ All subsequent legislative references in this draft Determination are to the ITAA 1997 unless otherwise indicated.

Example 1

2. *Taylor works as a public servant in a government department. She is paid her salary on a fortnightly basis by direct credit into her bank account. During the 2006-07 income year Taylor temporarily performed duties at a higher pay scale level. A subsequent review of payments by the department's personnel section established that Taylor had, due to administrative error, been mistakenly paid three amounts of \$500 that is, a total amount of \$1,500, during the 2006-07 income year. The circumstances are such that Taylor has an obligation to repay the three amounts paid by mistake. The mistakenly paid amount of \$1,500 was a gross amount from which tax was withheld. The amount of \$1,500 is not ordinary income of Taylor during the 2006-07 income year, as she was not beneficially entitled to that amount.*

Example 2

3. *Hannah is in regular receipt of a social security payment. A review of her circumstances established that she had, in error, been mistakenly paid amounts totalling \$825 during the 2006-07 income year, due to an incorrect income declaration by Hannah. The circumstances are such that Hannah has an obligation to repay the amounts paid by mistake. The amount of \$825 is not ordinary income of Hannah during the 2006-07 income year, as she was not beneficially entitled to that amount.*

Example 3

4. *Mike is a member of the Australian Defence Force (ADF) and during the 2005-06 income year was paid a retention bonus to encourage him to serve an agreed period in the ADF. The bonus was paid as a lump sum, and was required to be repaid on a pro-rata basis if he resigned before the end of the retention period. Mike resigned from the ADF during the 2006-07 income year (before the end of the retention period). The full amount of the retention bonus that Mike received is ordinary income in the income year in which he received it. He was beneficially entitled to that amount according to the terms and conditions of the retention agreement and the amount otherwise had the character of ordinary income. However, pursuant to section 59-30, the amount of the retention bonus that Mike must and does repay in a later year is thereafter, not assessable income and is not exempt income.*

Date of effect

5. It is proposed that when the final Determination is issued, it will apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Appendix 1 – Explanation

❶ ***This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.***

Explanation

6. Amounts paid to a taxpayer will be assessable income if they are income according to ordinary concepts (ordinary income) under section 6-5 or statutory income within the meaning of section 6-10.²

7. For an amount to be income according to ordinary concepts of a taxpayer it must be derived by the taxpayer. The proposition that a taxpayer will not derive ordinary income unless they are beneficially entitled to the amount has longstanding judicial support.

8. In *The Countess of Bective v. Federal Commissioner of Taxation* (1932) 47 CLR 417; [1932] HCA 22 amounts paid to the taxpayer from the trustee of a trust fund, for the purpose of the maintenance and support of the taxpayer’s daughter, were held not to be assessable income of the taxpayer. Dixon J said at 423 ‘...if she is not an object intended to be benefited at all by the provision for maintenance, the payments ought not, in my opinion, to be included as assessable income of the taxpayer...’.

9. In *Zobory v. Commissioner of Taxation* (1995) 64 FCR 86; 95 ATC 4251; (1995) 30 ATR 412 (*Zobory*), interest earned on funds misappropriated by the taxpayer from his employer was held not to be assessable income of the taxpayer. Burchett J concluded that the funds were held on constructive trust for the taxpayer’s employer and the interest was not income derived by the taxpayer. Burchett J held at FCR 89; ATC 4253; ATR 414 that ‘The fundamental principle which must be the starting point for a consideration of this case is the rule that the general provisions of the *Income Tax Assessment Act 1936* are directed to income to which a taxpayer is beneficially entitled.’

² Subsection 6-10(2) says, ‘Amounts that are *not* *ordinary income, but are included in your assessable income by provisions about assessable income, are called **statutory income**.’

10. Whether payments of certain worker's compensation amounts, to which the taxpayer was not legally entitled, were income derived by the taxpayer within the meaning of subsection 25(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) was considered in *Reiter v. Commissioner of Taxation* (2001) 113 FCR 492; 2001 ATC 4502; (2001) 47 ATR 533 (*Reiter*). The taxpayer challenged the Commissioner's position on derivation of payments where amounts were subsequently repaid. The Federal Court ruled in favour of the taxpayer on the basis that the payer, Workcover Corporation, had no legal obligation to pay the taxpayer fortnightly instalments of worker's compensation, and that the taxpayer had no beneficial entitlement to receive the amount. Therefore, the amounts were not derived for the purposes of subsection 25(1) of the ITAA 1936. Branson J cited the decision in *Zobory* and said at FCR 499; ATC 4507; ATR 539 that:

In my view, the applicant was not beneficially entitled to such of the amount of \$16,773 as was paid to him by the Corporation after the expiration of the stay of execution of the judgment of the Supreme Court of Victoria (the post-bar amount). The Corporation had no legal entitlement to pay him the post-bar amount by reason of the operation of subs 55(3) of the WRC Act. Conversely, the applicant had no legal entitlement to receive the post-bar amount. The respondent acknowledged that the Corporation had a statutory right of recovery in respect of the post-bar amount. The post-bar amount was not, in my view, in these circumstances income derived by the applicant within the meaning of subs 25(1) of the ITAA.

11. The decisions in these cases demonstrate that a taxpayer must be beneficially entitled to an amount for the amount to be derived by the taxpayer as ordinary income. *Reiter* illustrates the application of this proposition to a situation where the taxpayer's lack of beneficial entitlement coincided with their not being legally entitled to the amounts they had received. It was not a case where the court found that the taxpayer had become a trustee in any sense over these amounts (at FCR 499; ATC 4508; ATR 539-540).

12. Amounts mistakenly paid as salary or wages to employees (or as income support payments or worker's compensation amounts to persons), to which they are not beneficially entitled, but are obliged to repay, are not derived by these persons as ordinary income. Accordingly, such mistakenly paid amounts are not assessable income of these persons under section 6-5.

13. However, if the person's obligation to repay the mistakenly paid amount is subsequently waived, then there may be income tax or fringe benefits tax ramifications. For example, where the payer is the person's employer, a debt waiver fringe benefit may arise: refer to draft Taxation Determination TD 2007/D23. If the payer is not the person's employer, but there is a possibility the gain derived from waiving the debt occurs in some way as a reward for the person's services, or as a supplement of some sort to their income earning position, it may be advisable to apply for a private ruling about whether the gain is assessable income.

Appendix 2 – Your comments

14. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

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References

Previous draft:

Not previously issued as a draft

- ITAA 1997 6-10
- ITAA 1997 6-10(2)
- ITAA 1997 59-30

Related Rulings/Determinations:

TD 2007/D22; TD 2007/D23

Subject references:

- income
- income support payments
- salary and wages income
- workers' compensation income

Case references:

- Reiter v. Commissioner of Taxation (2001) 113 FCR 492; 2001 ATC 4502; (2001) 47 ATR 533; [2001] FCA 1068
- The Countess of Bective v. Federal Commissioner of Taxation (1932) 47 CLR 417; [1932] HCA 22
- Zobory v. Commissioner of Taxation (1995) 64 FCR 86; 95 ATC 4251; (1995) 30 ATR 412

Legislative references:

- ITAA 1936 25(1)
 - ITAA 1997 6-5
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ATO references

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