TR 92/3 - Income tax: whether profits on isolated transactions are income

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Australian Taxation Office

Taxation Ruling
Income tax: whether profits on isolated transactions are income

*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling provides guidance in determining whether profits from isolated transactions are income and therefore assessable under subsection 25(1) of the *Income Tax Assessment Act 1936*. In this Ruling, the term 'isolated transactions' refers to:

(a) those transactions outside the ordinary course of business of a taxpayer carrying on a business; and

(b) those transactions entered into by non-business taxpayers.

2. The Ruling sets out our views as to the application of the decision of the Full Court of the High Court of Australia in *FC of T v. The Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; 18 ATR 693.

3. In that case, the taxpayer company made an interest bearing loan to a subsidiary. Three days later, as had always been intended, the taxpayer assigned the right to receive interest income from the loan in return for a lump sum. The Court relied on 2 strands of reasoning in holding that the amount received by the taxpayer was income:

(a) The amount in issue was a profit from a transaction which, although not within the ordinary course of the taxpayer's business, was entered into with the purpose of making a profit and in the course of the taxpayer's business.

(b) The taxpayer sold a mere right to interest for a lump sum, that lump sum being received in exchange for, and as the present value of, the future interest it would have received. The taxpayer simply converted future income into present income.

4. The Ruling does not purport to provide a definitive exposition of the principles underlying the *Myer* decision because its full

implications will only completely emerge from consideration of the decision in later Court cases.

5. The Ruling does not consider the application of section 25A**,** the capital gains and capital losses provisions (Part IIIA) or Division 6A of Part III.

Ruling

A. Transactions with a profit-making purpose

6. Whether a profit from an isolated transaction is income according to the ordinary concepts and usages of mankind depends very much on the circumstances of the case. However, a profit from an isolated transaction is generally income when both of the following elements are present:

(a) the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain; and

(b) the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

7. The relevant intention or purpose of the taxpayer (of making a profit or gain) is not the subjective intention or purpose of the taxpayer. Rather, it is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances of the case.

8. It is not necessary that the intention or purpose of profit-making be the sole or dominant intention or purpose for entering into the transaction. It is sufficient if profit-making is a significant purpose.

9. The taxpayer must have the requisite purpose at the time of entering into the relevant transaction or operation. If a transaction or operation involves the sale of property, it is usually, but not always, necessary that the taxpayer has the purpose of profit-making at the time of acquiring the property.

10. If a transaction or operation is outside the ordinary course of a taxpayer's business, the intention or purpose of profit-making must exist in relation to the transaction or operation in question.

11. The transaction may take place in the course of carrying on a business even if the transaction is outside the ordinary course of the taxpayer's business.

12. For a transaction to be characterised as a business operation or a commercial transaction, it is sufficient if the transaction is business or commercial in character.

13. Some matters which may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction are the following:

(a) the nature of the entity undertaking the operation or transaction;

(b) the nature and scale of other activities undertaken by the taxpayer;

(c) the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;

(d) the nature, scale and complexity of the operation or transaction;

(e) the manner in which the operation or transaction was entered into or carried out;

(f) the nature of any connection between the relevant taxpayer and any other party to the operation or transaction;

(g) if the transaction involves the acquisition and disposal of property, the nature of that property; and

(h) the timing of the transaction or the various steps in the transaction.

14. It is not necessary that the profit be obtained by a means specifically contemplated (either on its own or as one of several possible means) when the taxpayer enters into the transaction. It is sufficient that the taxpayer enters into the transaction with the purpose of making a profit in the most advantageous way and that a profit is later obtained by any means which implements the initial profit-making purpose. It is also sufficient if a taxpayer enters into the transaction with the purpose of making a profit by one particular means but actually obtains the profit by a different means.

Summary

15. If a taxpayer carrying on a business makes a profit from a transaction or operation, that profit is income if the transaction or operation:

(a) is in the ordinary course of the taxpayer's business (see paragraph 32 for an explanation of the circumstances in

which a transaction is in the ordinary course of business) - provided that any gross receipt from the transaction or operation is not income; or

(b) is in the course of the taxpayer's business, although not within the ordinary course of that business, and the taxpayer entered the transaction or operation with the intention or purpose of making a profit; or

(c) is not in the course of the taxpayer's business, but

(i) the intention or purpose of the taxpayer in entering into the transaction or operation was to make a profit or gain; and

(ii) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction.

16. If a taxpayer not carrying on a business makes a profit, that profit is income if:

(a) the intention or purpose of the taxpayer in entering into the profit-making transaction or operation was to make a profit or gain; and

(b) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction.

B. Conversion of stream of income to a lump sum

17. An amount received for the transfer of a right to an income stream severed from the property to which it relates is income according to ordinary concepts. Future income is simply converted into present income. This is the case even if the income stream is produced by a contractual right rather than by the relevant property.

18. The above principle does not apply if:

(a) the right to income is not related to any underlying property e.g. a right to an annuity; or

(b) the right is related to underlying property which the transferor has not previously owned e.g. the transferor owns a right to income under a licence contract granting a right to use a trademark which the taxpayer has not owned.

19. An amount received in these circumstances could be income even if the second strand of reasoning in *Myer* does not apply. For example, if the transfer of the right to receive income is in the ordinary

course of the taxpayer's business or if the first strand of reasoning in *Myer* applies.

20. If a taxpayer transfers a right to an income stream, having previously disposed of the underlying property to which that right relates and retained the right to income, an amount received for that transfer is income.

Date of effect

21. This Ruling sets out the current practice of the Australian Taxation Office and does not contain any change in interpretation. Consequently, it applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Explanations

The Myer Case

22. In *Myer*, the taxpayer was the parent company in a group which carried on business predominantly in the areas of retail trading and property development. As part of a group reorganisation in March 1981, the taxpayer lent $80 million to a subsidiary for a period just exceeding 7 years at an interest rate of 12.5% per annum.

23. Three days later, as had always been intended, the taxpayer assigned to a finance company its right to receive the interest payable over the remainder of the loan period. As consideration for the assignment, the finance company paid the taxpayer company $45.37 million in a single sum. The sum was calculated on the basis of the outstanding interest payable discounted at the rate of 16% per annum.

24. The Commissioner treated the lump sum of $45.37 million as assessable income for the year ended 30 June 1981. On appeal, both the Supreme Court of Victoria and the Full Court of the Federal Court of Australia held that the amount was a non-assessable capital receipt.

25. The Commissioner then successfully appealed to the Full High Court. In a joint judgment, Mason ACJ, Wilson, Brennan, Deane and Dawson JJ held that the amount was income under both subsection 25(1) as income according to ordinary concepts and the second limb of paragraph 26(a) (now subsection 25A(1)) as a profit arising from the carrying on or carrying out of a profit-making undertaking or scheme.

26. The Full Court relied on two alternative reasons for its decision:

(a) The amount in issue was a profit from a transaction which, although not within the ordinary course of the taxpayer's business, was entered into with the purpose of making a profit and in the course of the taxpayer's business.

(b) The taxpayer sold its mere right to interest for a lump sum, that lump sum being received in exchange for, and as the present value of, the future interest it would have received. The taxpayer simply converted future income into present income.

A. Transactions with a profit-making purpose

27. The starting point in this area of the law is the statement of the Lord Justice Clerk (the Right Honourable J.H.A. Macdonald) in *Californian Copper Syndicate (Limited and Reduced) v. Harris* (1904) 5 TC 159 at 165-166 that:

> 'It is quite a well settled principle, in dealings with questions of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit ... assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. ... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being - Is the sum of gain that has been made a mere enhancement of values by realising a security, or is it a gain made in an operation of business in carrying out a scheme of profit-making?'

28. In *Blockey v. FC of T* (1923) 31 CLR 503 Isaacs J, in considering whether a profit from the purchase and sale of wheat scrip in an isolated transaction was assessable income, said at 508-509:

> 'But if a man, even in a single instance, risks capital in a commercial venture - say, in the purchase of a cargo of sugar or a flock of sheep - for the purpose of profit making by resale and makes profit accordingly, I do not for a moment mean to say he has not received "income" which is taxable. I intimated during the argument that this was possible; and I leave it open.'

29. The above statement of Isaacs J in *Blockey* was discussed by Mason J (as he was then) in *FC of T v. Whitfords Beach Pty Ltd* (1982) 150 CLR 355 at 376; 82 ATC 4031 at 4042; 12 ATR 692 at 705. His Honour agreed with the view that a profit made on the sale of property acquired for the purpose of profit-making by sale, when the purchase and sale is an isolated transaction not undertaken in the course of carrying on a business, could be income.

30. The view of Mason J was accepted and elaborated upon by the Full High Court in *Myer* at 163 CLR 209-210, 87 ATC 4366-7, 18 ATR 697:

> 'Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income (*Whitfords Beach* 150 CLR at 366-367, 376; 82 ATC at 4036-4037, 4042; 12 ATR at 695-696, 705). The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.'

Profits or gains in the ordinary course of business

31. In *Myer*, the High Court spoke of profits or gains made in the ordinary course of carrying on a business being income. The Court went on to say that, because a business is carried on with a view to profit, such profits or gains are invested with a profit-making purpose and are thereby stamped with the character of income.

32. It is not completely clear what the High Court meant in referring to 'profits or gains made in the ordinary course of carrying on a business'. However, we consider that there are two types of profits or gains which come within that description, namely:

(i) a profit or gain arising from a transaction which is itself a part of the ordinary business of a taxpayer (judged by reference to the transactions in which the taxpayer usually engages) - provided that the gross receipts from the transaction lack the character of income (*Commercial and General Acceptance Ltd v.*

FC of T (1977) 137 CLR 373 at 381; 77 ATC 4375 at 4380; 7 ATR 716 at 722); and

(ii) a profit or gain arising from a transaction which is an ordinary incident of the business activity of the taxpayer, although not a transaction entered into directly in its main business activity e.g. profits of insurance companies and banks on the sale of investments are generally income (*Chamber of Manufactures Insurance Ltd v. FC of T* (1984) 2 FCR 455; 84 ATC 4315; 15 ATR 599 and *C of T v. Commercial Banking Co. of Sydney* (1927) 27 SR(NSW) 231).

(Support for this view is found in the judgment of Hill J in *Westfield Ltd v. FC of T* 91 ATC 4234; (1991) 21 ATR 1398.)

Profits or gains in isolated transactions

33. The views expressed in *Whitfords Beach* and *Myer* that profits from isolated transactions can be assessable income must be looked at in the context of the facts involved in those cases. In *Myer*, the taxpayer was carrying on a large business at the time it entered into the transactions and, in *Whitfords Beach,* the taxpayer company embarked on a substantial business venture.

34. Nevertheless, there is a strong line of reasoning through the judgments in *Whitfords Beach* and *Myer* that suggests that profits made by a taxpayer who enters into an isolated transaction with a profit-making purpose can be assessable income. In *Myer*, at 163 CLR 213; 87 ATC 4369; 18 ATR 699-700, the Full High Court had this to say about the nature of profits from isolated transactions:

> 'It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realisation. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.'

35. A profit from an isolated transaction is therefore generally assessable income when both of the following elements are present:

(a) The intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain.

(b) The transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

36. The courts have often said that a profit on the mere realisation of an investment is not income, even if the taxpayer goes about the realisation in an enterprising way. The expression 'mere realisation' is used to contradistinguish a business operation or a commercial transaction carrying out a profit-making scheme (*Myer* at 163 CLR 213; 87 ATC 4368-4369; 18 ATR 699-700). If a transaction satisfies the elements set out in paragraph 35 it is generally not a mere realisation of an investment.

37. In considering whether a profit is assessable income, it is important not to apply the principles enunciated in *Myer* as if they are statutory tests. They are general principles, not conclusive tests, to be considered in deciding whether a profit is income.

Taxpayer's intention or purpose

38. The intention or purpose of the taxpayer (of making a profit or gain) referred to in *Myer* is not the subjective intention or purpose of the taxpayer. Rather, it is the taxpayer's intention or purpose discerned from an objective consideration of the facts and circumstances of the case. This is implicit from what the Court said, in the passage quoted in paragraph 30 above:

> '..it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income..'.

(R.W. Parsons, 'Income Taxation In Australia', The Law Book Company Limited, 1985 at p. 202 also refers to '...the objective inference of profit-purpose, which may be thought to be required by the ordinary usage notion [of an isolated business venture]'.)

39. If the taxpayer is a company, the purposes of those who control it are its purposes (*Whitfords Beach* at 150 CLR 370; 82 ATC 4039; 12 ATR 701).

40. It is not necessary that the intention or purpose of profit-making be the sole or dominant intention or purpose for entering into the

transaction. It is sufficient if profit-making is a significant purpose. This is clear from specific statements of the Federal Court in the following cases: *FC of T v. Cooling* 90 ATC 4472 at 4484; 21 ATR 13 at 26; *Moana Sand Pty Ltd v. FC of T* 88 ATC 4897; 19 ATR 1853; *AGC Investments Ltd v. FC of T* 91 ATC 4180; 21 ATR 1379. See also *Forwood Down and Co Ltd v. Commissioner of Taxation (WA)* (1935) 53 CLR 403 (especially Evatt J) and Jacobs J. in *London Australia Investment Co Ltd v. FC of T* 77 ATC 4398 at 4409-4411; 7 ATR 757 at 770-772.

41. The taxpayer must have the requisite purpose at the time of entering into the relevant transaction or operation. If a transaction or operation involves the sale of property, it is usually necessary that the taxpayer has the purpose of profit-making at the time of acquiring the property. However, as the High Court decisions in *White v. FC of T* (1968) 120 CLR 191; 15 ATD 173 and *Whitfords Beach* demonstrate, that is not always the case. (See also Menzies J in *FC of T v. N.F. Williams* (1972) 127 CLR 226 at 245; 72 ATC 4188 at 4192-4193; 3 ATR 283 at 289 and *Whitfords Beach Pty Ltd v. FC of T* (F.C.) 79 ATC 4648 at 4659; 10 ATR 549 at 567).

42. For example, if a taxpayer acquires an asset with the intention of using it for personal enjoyment but later decides to venture or commit the asset either:

(a) as the capital of a business; or

(b) into a profit-making undertaking or scheme with the characteristics of a business operation or commercial transaction,

the activity of the taxpayer constitutes the carrying on of a business or a business operation or commercial transaction carrying out a profit-making scheme, as the case may be. The profit from the activity is income although the taxpayer did not have the purpose of profit-making at the time of acquiring the asset.

43. If a transaction or operation is outside the ordinary course of a taxpayer's business, the intention or purpose of profit-making must exist in relation to the transaction or operation in question (*FC of T v. Spedley Securities Limited* 88 ATC 4126 at 4130; 19 ATR 938 at 942).

44. It is not our view, nor has it ever been, that all receipts or profits of a business are income. For example, when a taxpayer derives a profit from a transaction outside the ordinary course of carrying on its business and the taxpayer did not enter that transaction with the purpose of making a profit, the profit is not assessable income.

In the course of carrying on a business

45. The transaction may take place in the course of carrying on a business even if the transaction is outside the ordinary course of the taxpayer's business. As the Full High Court said in *Myer* at 163 CLR 215; 82 ATC 4370; 18 ATR 701:

> 'If the profits be made in the course of carrying on a business that in itself is a fact of telling significance. It does not detract from its significance that the particular transaction is unusual or extraordinary, judged by reference to the transactions in which the taxpayer usually engages, if it be entered into in the course of carrying on the taxpayer's business.'

Business operation or commercial transaction

46. If a taxpayer enters into a transaction in the course of carrying on a business, it is not necessary to consider whether it is a business operation or commercial transaction. However, it is necessary to consider this issue if the taxpayer is not carrying on a business or if the transaction or operation is not in the course of the taxpayer's business, e.g. if a sole trader carrying on a retail business acquires shares.

47. For a transaction to be characterised as a business operation or a commercial transaction, it is sufficient if the transaction is business or commercial in character (see *Whitfords Beach* at 150 CLR 379; 82 ATC 4044; 12 ATR 707). Whether a particular transaction has a business or commercial character depends very much on the circumstances of the case.

48. In *Myer*, the High Court did not set out guidelines as to what constitutes a business operation or commercial transaction. However, it did regard the following instances as being such operations or transactions:

(i) A syndicate purchased a mining property for the purpose of resale at a profit, rather than deriving income from mining operations on the property, and later sold the property at a profit (*Californian Copper Syndicate v. Harris)*.

(ii) A company engaged in exploiting a particular invention by granting licences under patents acquired additional patents in relation to the invention and, as always contemplated, sold those patents at a profit (*Ducker v. Rees Roturbo Development Syndicate* Ltd [1928] AC 132).

(iii) A partnership purchased a complete spinning plant with a view to resale at a profit, having no intention of using the plant to derive income from spinning, and later sold the plant at a profit (*Edwards v. Bairstow* [1956] AC 14).

(iv) A company which owned beachfront land suffered a change in ownership and then procured changes of zoning, developed the land as a residential subdivision and sold the vacant subdivided lots for a profit of several million dollars (*Whitfords Beach*).

49. In very general terms, a transaction or operation has the character of a business operation or commercial transaction if the transaction or operation would constitute the carrying on of a business except that it does not occur as part of repetitious or recurring transactions or operations. Some factors which may be relevant in considering whether an isolated transaction amounts to a business operation or commercial transaction are the following:

(a) the nature of the entity undertaking the operation or transaction (*Ruhamah Property Co. Ltd. v. F C of T* (1928) 41 CLR 148 at 154; *Hobart Bridge Co. Ltd. v. FC of T* (1951) 82 CLR 372 at 383; *FC of T v. Radnor Pty Ltd* 91 ATC 4689; 22 ATR 344). For example, if the taxpayer is a corporation with substantial assets rather than an individual, that may be an indication that the operation or transaction was commercial in nature. However, if the taxpayer acts in the capacity of trustee of a family trust, the inference that the transaction was commercial or business in nature may not be drawn so readily;

(b) the nature and scale of other activities undertaken by the taxpayer (*Western Gold Mines N.L. v. C. of T. (W.A.)* (1938) 59 CLR 729 at 740);

(c) the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;

(d) the nature, scale and complexity of the operation or transaction;

(e) the manner in which the operation or transaction was entered into or carried out. This factor would include whether professional agents and advisers were used and whether the operation or transaction took place in a public market;

(f) the nature of any connection between the relevant taxpayer and any other party to the operation or transaction. For example, the relationship between the parties may suggest that the operation or transaction was essentially a family dealing and not business or commercial in nature;

(g) if the transaction involves the acquisition and disposal of property, the nature of that property (*Edwards v. Bairstow*; *Hobart Bridge* 82 CLR at 383). For example, if the property has no use other than as the subject of trade, the conclusion that the property was acquired for the purpose of trade and, therefore, that the transaction was commercial in nature, would be readily drawn; and

(h) the timing of the transaction or the various steps in the transaction (*Ruhamah Property* 41 CLR at 154). For example, if the relevant transaction consists of the acquisition and disposal of property, the holding of the property for many years may indicate that the transaction was not business or commercial in nature.

50. The principal case since *Myer* in which a profit-making transaction has been held to be a business operation or commercial transaction is *FC of T v. Cooling*. There, the Full Federal Court (Lockhart, Gummow and Hill JJ) held that a payment received by a firm of solicitors as an incentive for it to relocate to new premises was income according to ordinary concepts. At the relevant time in the city where the firm practised, it was an ordinary incident of leasing premises of the type in question to receive incentive payments. Hill J (with whom the other judges agreed on the subsection 25(1) issue) said that where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity. At 90 ATC 4484; 21 ATR 27 Hill J concluded:

> 'In my view the transaction entered into by the firm was a commercial transaction; it formed part of the business activity of the firm and a not insignificant purpose of it was the obtaining of a commercial profit by way of the incentive payment.'

Whether there must be a purpose of profit-making by the very means by which the profit was in fact made

51. Assuming that both of the elements set out in paragraph 35 are met, if taxpayer earns a profit by the exact means it contemplated at

the time of entering the transaction, the profit is clearly income (see *Myer*, especially the passage set out in paragraph 30 above). The simplest example is where a taxpayer acquired property for the purpose of selling it at a profit and later did sell it at a profit . What if, however, at the time a taxpayer enters a transaction with a profit-making purpose it contemplates a number of possible methods of making that profit or it did not have in mind any particular means of making the profit?

52. This issue was considered recently by the Full Federal Court in *Westfield Limited v FC of T*. At 91 ATC 4243; 21 ATR 1408, Hill J (with whom Lockhart and Gummow JJ agreed) said:

> '...where a transaction falls outside the ordinary scope of the business, so as not to be a part of that business, there must exist, in my opinion, a purpose of profit-making by the very means by which the profit was in fact made. So much is implicit in the decision of the High Court in *Myer*.'

53. His Honour limited this broad statement when he pointed out:

> 'There may be a case, the present is not one, where the evidence establishes that the taxpayer has the purpose or intention of making a profit by turning an asset to account, although the means to be adopted to generate that profit have not been determined: cf *Steinberg v Federal Commissioner of Taxation* (1972-75) 134 CLR 640; 75 ATC 4221; 5 ATR 594...
>
> While a profit-making scheme may lack specificity of detail, the mode of achieving that profit must be one contemplated by the taxpayer as at least one of the alternatives by which the profit could be realised. Such was the case in *Steinberg*.'

54. His Honour then said:

> 'But, even if that goes to far, it is difficult to conceive of a case where a taxpayer would be said to have made a profit from the carrying on, or carrying out, of a profit making scheme, where, in the case of a scheme involving the acquisition and resale of land, there was, at the time of acquisition, no purpose of resale of land, but only the possibility (present, one may observe, in the case of every acquisition of land) that the land may be resold. The same may be said to be the case where subsection 25(1) is involved.'

55. The Commissioner unsuccessfully applied to the High Court for special leave to appeal against the Full Federal Court decision. The application was refused on the basis that the case turned on its own particular facts.

56. In our view a profit made in either of the following situations is income:

(a) a taxpayer acquires property with a purpose of making a profit by which ever means prove most suitable and a profit is later obtained by any means which implements the initial profit-making purpose (*Steinberg*; *Premier Automatic Ticket Issuers Ltd v. FC of T* (1933) 50 CLR 268 at 300; *Myer*, especially at 163 CLR 211; 87 ATC 4367; 18 ATR 698); or

(b) a taxpayer acquires property contemplating a number of different methods of making a profit and uses one of those methods in making a profit.

57. We also consider that an assessable profit arises if a taxpayer enters into a transaction or operation with a purpose of making a profit by one particular means but actually obtains the profit by a different means. Thus, a taxpayer may contemplate making a profit by sale but may ultimately obtain it by other means (such as compulsory acquisition, through a company liquidation or a distribution in specie) that were not originally contemplated.

58. Dicta of Hill J in *Westfield* have been cited as being contrary to this view. However, our view follows from the earlier Full Federal Court decision in *Moana Sand Pty Ltd v. FC of T*. In a joint judgment the Court (Sheppard, Wilcox and Lee JJ) applied the *Myer* decision and held that a profit on the disposal of land by means of compulsory acquisition was income according to ordinary concepts. The Court reached this conclusion notwithstanding the finding of fact that the taxpayer acquired the land for 2 purposes. The purposes were working and/ or selling the sand and thereafter holding the land until it became 'ripe' for subdivision, when it would be sold either to another family company for the purpose of subdivision or to a third party subdivider, whichever gave the largest financial return to the taxpayer. In any event, the law on the issue raised in paragraph 57 above is not clear and, in our view, needs further judicial elucidation.

B. Conversion of stream of income to a lump sum

59. In *Myer,* the Full High Court distinguished the assignment of the right to receive interest from *Inland Revenue Commissioners v. Paget* [1938] 2 KB 25 where the English Court of Appeal held that the proceeds of the sale of interest coupons attached to foreign bearer bonds were capital. At 163 CLR 218, 87 ATC 4371, 18 ATR 703-704 the Full High Court said:

> 'But the interest which becomes due is not the produce of the mere contractual right to interest severed from the debt for the money lent. Interest is regarded as flowing from the

> principal sum..... The source of interest is never the mere covenant to pay. Interest is not like an annuity. .....If a lender who sells a right to interest severed from the debt were regarded as disposing of an income-producing right, *Paget* would indicate that the price should be treated as capital. But the contractual right is not the source of the interest to which it relates: a contractual right severed from the debt is not the structure which produces that income.'

60. At 163 CLR 219, 87 ATC 4372, 18 ATR 704, the Court continued:

> 'Unlike the sale of the coupons in *Paget*, the sale of a right to interest severed from the debt is not a sale of a tree of which the future payments are the fruit. The present case may thus be distinguished from the view of the facts which was the foundation of the decision in *Paget*. If *Paget* is not to be distinguished in this way, we should be unable to accept its authority for the purposes of the Act.'

61. From the above passages, it is clear that if a stream of income can be regarded as flowing from property (rather than merely from a contractual right to that income) consideration received for the transfer of the right - without transfer of the property to which the contractual right relates - is income according to ordinary concepts.

62. As the Full High Court was apparently willing to accept that *Paget* is not good authority in Australia, the *Myer* decision left open the assessability under subsection 25(1) of a lump sum received for the transfer of a contractual right to a stream of income without the property to which it relates where the income is properly regarded as produced by the contractual right e.g., a royalty stream. This issue was recently considered in *Henry Jones (IXL) Limited v. FC of T* 91 ATC 4663, 22 ATR 328.

63. In *Henry Jones* the taxpayer and a subsidiary entered into a 10 year agreement in December 1981 with two arm's length companies under which the taxpayer and the subsidiary granted a licence to the other companies to use certain labels in return for royalties spread over the term of the contract. In May 1982 the taxpayer and the subsidiary assigned their rights to receive the royalties to a finance company for a lump sum of $7.6 million. Before it entered into the licence agreement, the taxpayer intended to assign the rights under it for lump sum.

64. The Full Federal Court held that the receipt was assessable income under subsection 25(1) on the basis of the second strand of reasoning in *Myer*. Hill J (with whom Jenkinson and Heerey JJ. agreed on this issue) said at 91 ATC 4675; 22 ATR 341:

> 'Notwithstanding some doubt, I think *Myer* must be taken as establishing that, except in the case of the assignment of an annuity where the income arises from the very contract assigned, an assignment of income from property without an assignment of the underlying property right will, no matter what its form, bring about the result that the consideration for that assignment will be on revenue account, as being merely a substitution for the future income that is to be derived. Thus, the fact that the future income may be secured by an agreement, and that the assignment is of the right title and interest of the assignor in that agreement will not affect the result.'

65. Thus, an amount received for the transfer of a right to an income stream severed from the property to which it relates is income according to ordinary concepts. Future income is simply converted into present income. This is the case even if the income stream is produced by a contractual right rather than by the relevant property.

66. *Myer* and *Henry Jones* did not squarely address the case of a taxpayer assigning a right to a stream of income for a lump sum in the following 3 situations:

(a) The taxpayer's right is unrelated to any other property but is not an annuity.

(b) The taxpayer's right is related to underlying property which the taxpayer has never owned e.g. the taxpayer (like the assignee in *Henry Jones*) owns a right to income under a licence contract granting a right to use a trademark which the taxpayer has not owned.

(c) The taxpayer previously disposed of the underlying property to which the right to income relates and retained that right e.g. a taxpayer sold a trademark but, under the sale agreement, retained a right to a share of the income from licences granting the right to use that trademark.

67. The second strand of reasoning in *Myer* does not apply if the right to income transferred is unrelated to any other property. The reasoning in both *Myer* and *Henry Jones* emphasises the fact that the right to income was severed from the underlying property. There is no such severing if a taxpayer transfers a right to income which is unrelated to any other property. An annuity is an example of such a right - it is not the only right to a stream of income which does not fall within the second strand of reasoning in *Myer*.

68. Similarly, the second strand of reasoning in *Myer* does not apply if the taxpayer transferring a right to income has never owned the

underlying property. In terms of the analogy of the tree and the fruit referred to in *Myer*, the transfer of the right to income is the sale of the tree of which the future payments are the fruit.

69. An amount received in the situations considered in paragraphs 67 and 68 could be income even if the second strand of reasoning in *Myer* does not apply. For example, it would be income if the transfer of the right to income is in the ordinary course of the transferor's business or if the first strand of reasoning in *Myer* (the profit-making purpose strand) applies.

70. We consider that the second strand of reasoning in *Myer* does apply if the transferor previously disposed of the underlying property to which the right to income relates and retained that right. The taxpayer has severed a right to income from its total interest and disposed of it separately from the underlying property. The fact that the right was disposed of after the underlying property rather than before (as it was in *Henry Jones*) does not affect the character of the receipt. The receipt would have been income if the right to income had been disposed of before the underlying property. It is also income if it is disposed of after the underlying property. In terms of the analogy of the fruit and the tree, the taxpayer has taken the fruit from the tree, sold the tree and later sold the fruit.

Examples

71. The following examples are illustrations of the way in which the above principles are applied. It is important to remember, especially in applying the first strand of reasoning in *Myer* (the profit-making purpose strand), that whether a profit constitutes income depends very much on the circumstances of the particular case. Consequently, the answers given in the following examples are not determinative of our views on cases with similar, but different, facts.

A. Transactions with a profit-making purpose

Example 1

72. Ms Donovan, a public servant, purchased 10,000 shares in a listed public company at a price of $1 each and sold them 18 months later for $2 each. During that period, the company paid one small dividend. Donovan was not carrying on a business of trading in shares. A significant purpose of Donovan in acquiring the shares was to make a profit from an increase in the value of the shares.

73. The profit made on the sale of the shares is not income. The transaction was merely an investment, not a business operation or commercial transaction.

Example 2

74. Mr Leary carried on a pharmacy business as a sole trader. He acquired a residential property and leased the property to an arm's length party for 3 years, bringing small net returns. Leary then sold the property at a large profit during a property boom. He had no previous dealings in property, other than as lessee of his shop premises.

75. Mr Leary's profit is not income because the acquisition and sale of the residential property was not a business operation or commercial transaction. It was the acquisition and sale of an investment, even if a significant purpose of Leary in acquiring the property was profit-making.

Example 3

76. A taxpayer owned shares in a public company with a market value of $100,000. The taxpayer's shareholding had been built-up over a period of 5 years and acquired at a cost of $40,000. In acquiring the shares the taxpayer hoped to build up a nest egg for her retirement. The taxpayer sold the shares to her 4 children for $80,000 and used the proceeds in purchasing a unit in a retirement home.

77. The profit made is not income. The transaction was not business or commercial in character. The sale of the shares below their market price and the fact that the purchasers are family of the taxpayer indicate that the transaction was essentially a family dealing.

Example 4

78. Mr Goldfinger purchased a number of gold bars for $100,000 and, following a sharp rise in the price of gold, sold the gold bars one week later for $110,000. Goldfinger did not carry on a business and had no previous dealings in gold.

79. The profit of $10,000 is income and assessable under subsection 25(1). It can be inferred from the objective circumstances (especially the quick sale following a rise in price and the fact that the asset had no immediate use other than as an object of trade) that profit-making was a significant purpose of Goldfinger in acquiring the gold bars. Furthermore, the substantial amounts of money involved and the nature of the asset traded lead to the conclusion that the transaction was commercial in nature.

Example 5

80. Hungry Ltd, a public company, made a takeover bid for another public company, Morsel Ltd, in which it already held a 15% interest. Shortly after, Ravenous Ltd also made a takeover bid for Morsel. Ravenous' takeover bid was successful and Hungry's failed. Hungry sold to Ravenous the shares it had acquired in Morsel at a large profit.

81. Hungry was a holding company in a group of companies. Many of the entities in the company group had previously been involved in takeovers of other companies. Hungry had not previously been involved in a takeover attempt and had only disposed of shares in the course of restructuring the company group. From the time Hungry began to acquire shares in Morsel the directors of Hungry had hoped to acquire control of Morsel - they were not interested in a 'passive investment'. The contingency plan of the directors in the event that control could not be obtained was to dispose of the shares in Morsel at a profit.

82. The profit on the sale of the shares is income. A substantial, but not dominant, purpose of Hungry in acquiring the shares was to dispose of them at a profit because the contingency plan was to dispose of the shares at a profit. Furthermore, the acquisition and sale of the shares was effected in the course of the taxpayer's business.

Example 6

83. Conglomerate Ltd, a large public company, made a takeover bid for Awful Ltd, the owner of lands containing a large mineral deposit. Conglomerate intended to obtain control of Awful and expedite the mining of the deposit. The takeover bid was unsuccessful and Awful did not commence mining operations. Conglomerate held its Awful shares for about 2 years before selling the shares at a profit.

84. Assuming that the unsuccessful takeover bid was not made in the ordinary course of Conglomerate's business, the profit on the sale of the shares is not income. The evidence shows that Conglomerate acquired the shares to obtain control of Awful and derive dividends generated by mining activities of that company, not to make a profit from the sale of the shares.

Example 7

85. A family company acquired 500 hectares of land, which had been used as a grazing property, for $1 million. The company was formed for the purpose of acquiring the land and Mr and Mrs Soil owned all the shares in the company and were the directors. Four

years after acquisition, the Soils sold all their shares in the company to an arm's length party for $2 million.

86. The Soils maintain that the property was purchased for use as a grazing property but the land was never so used after the company acquired it. The Soils had no knowledge of, or experience in, grazing but on several occasions they had been involved in the purchase and resale of land. Furthermore, under local government legislation, the land had been zoned for residential development before the company acquired it.

87. The profit made by the Soils is income. The objective evidence establishes that the Soils incorporated the company and arranged for the company to acquire the land with the purpose of making a profit from the anticipated appreciation in the value of the land.

88. The profit from the appreciation in the value of the land could have been realised in a number of ways. For example, the company could have sold the land, the shares in the company could have been sold or the company could have been placed in voluntary liquidation and the land distributed in specie by the liquidator. It is not necessary that the Soils planned each step which led to the making of the profit. It is sufficient that the Soils intended to make a profit from the appreciation of the land when they entered the transaction and that the intended profit was made.

89. Furthermore, the acquisition of the land through the company and the subsequent sale of the shares in that company was a business operation or commercial transaction because of the following factors: the use of a corporate structure, the large amounts of money involved and the Soils' other dealings in land.

Example 8

90. Mr Develop has been involved in property development, mainly through a company group he controls, for many years. In recent years, each acquisition of property by the group has been effected by a different company. Thus, each company in the group of more than 50 companies has been involved in only one acquisition, development and sale of property. Over the last 5 years the companies have made profits totalling more than $50 million from the development and sale of properties.

91. The profits derived by each of the companies from the development and sale of property are income. In determining whether a company has the purpose of profit-making, the acts and intentions of the natural persons who control the company should be examined.

The actions of Mr Develop in repeatedly using companies he controls to make profits from the development and sale of property indicate that the purpose of each company in acquiring property was profit-making.

92. Furthermore, the acquisition, sale and development of the properties undertaken by the companies amount to a business operation or commercial transaction. The scale of the activities, the nature of the entities (members of a large group of companies), and the business-like way in which the companies have carried out their development activities indicate that the transactions were business or commercial in nature.

Example 9

93. Mr Bates purchased a motel in a country town intending to carry on a business as the owner and operator of that motel. He ran the motel for 7 years earning moderate returns and then sold it at a large profit. Mr Bates had not previously purchased property other than a house in which he had lived.

94. The profit on the sale of the motel is not income. It cannot be inferred from the objective facts that Mr Bates acquired the motel with a purpose of making a profit (as distinct from income from the carrying on a business). Furthermore, the sale of the motel was not made in the ordinary course of carrying on a business. The motel was a structural asset of the business.

B. Conversion of stream of income to a lump sum

Example 10

95. A company carried on a manufacturing business and also derived income from the rental of a large number of properties. The company assigned to an unrelated party its right to receive rental income from the properties in return for a lump sum.

96. The lump sum received is income. There has been a transfer of a right to a stream of income from property without the underlying property. The company has converted future income to present income.

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