The Tax Summit

Session 18.4: Deep dive into derivation of income

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Ermelinda Kovacs
Ground Floor Wentworth Chambers

Fiona Moore, CTA
EY

Contents

1. Introduction

Professor Parsons, in his seminal work *Income Taxation in Australia*, in the context of a discussion of *income* according to ordinary usage, summarised 15 propositions (at p 26). Proposition 1 is as follows:

> "An item of an income character is derived when it has "come home" to the taxpayer. The presence of illegality, immorality or ultra vires does not preclude derivation."

Self-evidently, derivation is fundamental to the concept of *income* according to ordinary usage. It is concerned with the time at which an item is income, so that it falls to be included in a return of income for a year of income or comes to be subject to tax by withholding.

As will be explored in this paper, the time at which an item is income ultimately depends on the facts and the circumstances of the particular case at hand.

2. Derivation in context

Under s 6-5(2) of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**), an Australian resident's assessable income includes the ordinary income *derived* by the taxpayer directly or indirectly from all sources, whether in or out of Australia, during the income year.

Under ss 6-5(3)(a) of the ITAA 1997, a foreign resident's assessable income includes the ordinary income *derived* by the taxpayer directly or indirectly from all Australian sources during the income year.

Accordingly, whether an item of ordinary income is included in a taxpayer's assessable income for a particular income year falls to be determined by whether it was *derived* during that income year.

Whether an item of statutory income is included in a taxpayer's assessable income for a particular year falls to be determined by reference to the statute. For example:

(a) under ss 104-10(3) of the ITAA 1997, CGT Event A1 happens when the taxpayer "*enters into the contract for the disposal*" or if there is no contract, "*when the change of ownership occurs*";

(b) under s 44 of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**), whether dividends are to be included in the assessable income of a shareholder in a particular year depends on whether they were "*paid*" to the shareholder in that year;

(c) under ss 97(1)(a)(i) of the ITAA 1936, the assessable income of a beneficiary of a trust estate who is not under any legal disability and is "*presently entitled*" to a share of the net income of the trust estate includes "*so much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident*";

(d) under s 128B of the ITAA 1936, liability to withholding tax arises in respect of income that "*is derived*" by a non-resident (as to which, see further at Section 6 below); and

(e) in relation to the Taxation of Financial Arrangements (**TOFA**), the timing of the recognition of gains and losses from financial arrangements is determined with reference methods prescribed by Division 230 of the ITAA 1997.

3. Meaning of *derived*

What then is the meaning of the word *derived*? The Act does not define the word *derived*, although its meaning is affected by ss 995-1(1) and ss 6-5(4) of the ITAA 1997.

3.1 Ordinary meaning

The ordinary meaning of *derived* was described by Gibbs J in *Brent v Federal Commissioner of Taxation* [1971] HCA 48; 125 CLR 418 (***Brent***) at 427-428 as follows (references omitted):

> "The word "derived" is not necessarily equivalent in meaning to "earned". "Derive" in its ordinary sense, according to the Oxford English Dictionary means "to draw, fetch, get, gain, obtain (a thing from a source)". It has become well established that unless the Act makes some specific provision on the point the amount of income derived is to be determined by the application of ordinary business and commercial principles and that the method of accounting to be adopted is that which "**is calculated to give a substantially correct reflex of the taxpayer's true income**." (emphasis added).

In *Commissioner of Taxes (SA) v Executor, Trustee and Agency Co of South Australia* [1938] HCA 69; 63 CLR 108 (***Carden's Case***), Dixon J (with whom Rich and McTiernan JJ agreed) said at 155:

> "Speaking generally, in the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in a **realized or immediately realizable form**." (emphasis added).

In *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* [1965] HCA 58; 114 CLR 314 (***Arthur Murray***), Barwick CJ, Kitto and Taylor JJ at 318 said that Dixon J's reference in *Carden's Case* to monies having *"come home"* to the taxpayer was a reference not simply to beneficial receipt but to the reaching of a situation in which monies received might properly be counted as gains completely made, so that there was neither legal nor business unsoundness in regarding them, without qualification, as income derived.

The Act does not establish a *method* to be adopted as a general rule to determine the amount of income derived by a taxpayer. A consideration of the relevant *methods* that may apply is set out in Section 4 below.

3.2 Statutory modification

Section 995-1(1) of the ITAA 1997 provides that "***derive** has a meaning affected by subsection 6-5(4)*". Section 6-5(4) of the ITAA 1997 provides that:

> "In working out whether you have derived an amount of *ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct."

Constructive derivation pursuant to ss 6-5(4) of the ITAA 1997 is considered in Section 5 below.

4. Methods of tax accounting

4.1 *Accrual* and *receipts* bases

Under the *accruals* method, an amount of ordinary income will be included in assessable income when the taxpayer has *earned* the income. Under the *receipts* method, an amount of ordinary income will be included in assessable income when the taxpayer receives the income. As the cases summarised below demonstrate, the method to be used by the taxpayer depends on its *actual appropriateness*.

4.2 *Carden's Case*

In *Carden's Case*, the central issue was whether the income of a medical practitioner was derived on an *accruals* or a *receipts* basis. Up to and including the year ended 30 June 1929, Dr Carden included income in his return on an *accruals* basis. Subsequently, Dr Carden returned his income on a *receipts* basis. The majority of the High Court held, that the *receipts* basis was the appropriate method of accounting for Dr Carden's income.
Dixon J relevantly observed at 156:

> "Unless in the statute itself some definite direction is discoverable, I think the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness. In other words, the inquiry should be whether in the circumstances of the case it **is calculated to give a substantially correct reflex of the taxpayer's true income**." (emphasis added).

In determining what was a "*substantially correct reflex*" of Dr Carden's income, Dixon J stated at 157 to 158:

> "The considerations which appear to me to affect any such question are to be found in the nature of the profession concerned and, indeed, the actual mode in which it is practised in a given case. Where there is nothing analogous to a stock of vendible articles to be acquired or produced and carried by the taxpayer, where outstandings on the expenditure side do not corresponded to, and are not naturally connected with, the outstandings on the earnings side and where there is no fund of circulating capital from which income or profit must be detached for actual enjoyment, but where, on the contrary, the receipts represent in substance a reward for professional skill and personal work to which the expenditure on the other side of the account contributes only in a subsidiary or minor degree, then I think according to ordinary conceptions the receipts basis forms a fair and appropriate foundation for estimating professional income…Both in Great Britian and Australia it has been common practice to return and to assess professional income on a receipts basis…"

Dixon J ultimately found that the little certainty about the payment of fees in the medical practice to be decisive in concluding that the *receipts* basis was appropriate.

4.3 *Henderson v Federal Commissioner of Taxation* (1970) 119 CLR 612 (*Henderson*)

In *Henderson*, the taxpayer was a partner in an accounting firm. For many years, the partnership returned its net income on a *receipts* basis, and the individual partners followed suit. In the year ended 30 June 1965, the partnership adopted an *accruals* basis for recognising its income and the taxpayer (one of the partners) similarly returned his income on an *accruals* basis. As a result of the change, a sum of money effectively fell outside the tax net as it was *accrued* prior to the year ended 30 June 1965 (i.e. in a year in which the partnership applied the *receipts* basis) and it was *received* in a year in which the partnership applied the *accruals* basis.

Consistently with *Carden's Case*, the Commissioner took the view that the appropriate method for determining when the taxpayer derived his income was the *receipts* method. However, the High Court took the view that the operation of the partnership that was considered in *Henderson* could be viewed in "*sharp contrast*" (at 646) to the circumstances in *Carden's Case*. In this respect, it was held that the taxpayer's income was to be retuned on an *accruals* basis having regard to the following factors (none of which were necessarily determinative on their own):

(a) the partnership comprised a number of people, each contributing to the net income (as compared to the sole practitioner in *Carden's Case*);

(b) as the business of the partnership grew, work was completed on a credit basis rather than clients paying for the work as it was performed;

(c) the *accruals* basis of accounting had the effect of each partner being "*taxed upon a remuneration proportionate to his contribution to the total earnings, and furthermore, that neither a retiring partner nor continuing partners would suffer if a retirement occurred when there was a large sum outstanding for work done but not yet paid for*" (at 627); and

(d) the income of the partnership was described to be "*continuous*" and not *"cyclical"* (at 628).

4.4 *Barratt v Federal Commissioner of Taxation* (1992) 36 FCR 222 (*Barratt*)

Barratt concerned partners in a pathology practice. The partnership returned its net income on a *receipts* basis. However, the Commissioner was successful in arguing an *accruals* basis was the more appropriate method.

The Commissioner submitted that the facts in *Barratt* could be distinguished from *Carden's Case* because while some of the income was professional income, a substantial portion of the income was referrable to the work of nurses and pathology technicians. The practice was also reliant on technical (testing) equipment. In this respect, the Commissioner argued it could not be said that the income of the partnership was referrable to the personal exertion of the partners. Accordingly, he submitted that the 'accruals' method was appropriate. That submission was accepted by the Court.

In addition, the fact that specific legislation provided that practitioners could not sue for recovery of fees until six months after issuing a bill, did not change the conclusion that an *accruals* basis of accounting was more appropriate. That is, it did not preclude the patients from paying the invoices within the six month period. Gummow J relevantly observed (at [41]):

> "It would be to depart from the truth and reality of the situation to treat the provisions of the State statute as deferring what otherwise would be the earlier derivation of income."

Accordingly, the Court accepted the Commissioner’s submission that the income was derived when the debt for the fee arose notwithstanding that it was subject to an impediment as to recovery such that it could not be sued for until after an interval.

4.5 *Arthur Murray*

The corporate taxpayer in *Arthur Murray* carried on a business of providing dancing lessons in respect of which fees were charged by the hour. Payment for the lessons was often made in advance. If a student did not complete a course of lessons, he or she had no contractual entitlement to a refund of the fees paid in advance. However, there were occasions on which refunds were provided. When the fees were received by the taxpayer, they were allocated to an ‘unearned income’ account and then subsequently transferred to an ‘earned income’ account. The taxpayer only included in assessable income fees in respect of lessons provided. The fees paid in advance were not included in assessable income.

The Commissioner made the relevant assessments on the basis that the fees received in advance of tuition possessed the character of assessable income in the company’s hands from the moment of receipt, so that in respect of a given year of income there was no need to distinguish between fees for which lessons had been given during the year and fees for which at the end of the year the lessons still remained to be given.

The High Court found in favour of the taxpayer. Barwick CJ, Kitto and Taylor JJ stated (at 319):

> “It is true that in a case like the present the circumstances of the receipt do not prevent the amount received from becoming immediately the beneficial property of the company; for the fact that it has been paid an advance is not enough to affect it with any trust or charge, or to place any legal impediment on the way of the recipient’s dealing with it as he will. But those circumstances nevertheless make it surely necessary, as a matter of good business sense, that the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back…The possibility of having to make such a payment back…is an inherent characteristic of the payment itself. In our opinion, it would be out of accord with the realities of the situation to hold, while the possibility remains, that the amount received has the quality of income derived by the company.”

5. Section 6-5(4) - Constructive receipt

5.1 *Statutory modification to the meaning of 'derived'*

As noted above, ss 995-(1) of the ITAA 1997 provides that "***derive** has a meaning affected by subsection 6-5(4)*". Section 6-5(4) of the ITAA 1997 provides that:

> "In working out whether you have derived an amount of ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct."

In *Blank v Commissioner of Taxation* (2016) 258 CLR 439, French CJ and Kiefel, Gageler, Keane and Gordon JJ relevantly observed at [79] (references omitted):

> "The object of s 6-5(4) is to prevent a taxpayer escaping the imposition of tax where, although income has not actually been paid to him or her, his or her resources have actually been increased "by the accrual of the income and its transformation into some form of capital wealth or its utilization for some purpose".

5.2 *WCVB v Commissioner of Taxation* [2024] AATA 1259 (*WCVB*)

In the recently decided *WCVB*, the Administrative Appeals Tribunal found that the taxpayer had not discharged its onus of proving that it had not constructively derived income under ss 6-5(4) of the ITAA 1997 in connection with a contract it was not a party to.

A summary of the facts is outlined below:

(a) In 2002, the taxpayer and a related entity acquired three blocks of land in Astoria for the sum of $3,125,000 as tenants in common with the taxpayer holding a 19/20th share.

(b) In or about June 2010, in his capacity as a director of the taxpayer and the related entity, Mr Smith executed the following contracts:

  (i) a contract dated 28 May 2010 for the sale of one of the blocks of land in Astoria for $2,000,000 to ABC (**First Contract**);

  (ii) a contract dated 2 June 2010 for the sale of another block of land in Astoria for $1,500,000 to ABC (**Second Contract**); and

  (iii) a contract dated 7 June 2010 for the sale of the final block of land in Astoria for $1,500,000 to ABC (**Third Contract**).

(c) The three blocks of land in Astoria were sold on revenue account. The taxpayer contended that it had only *received* and therefore *derived* $5,000,000 (being the sum of the three amounts set out in subparagraph (b) above) in connection with the sale of the land.

(d) On 7 June 2010, Zenith executed a 'Deed of Agreement' for the apparent sale of "*development documents*" in relation to "*a number of properties in Sydney*" including the three blocks of land in Astoria for $3,850,000 (excluding GST) with ABC (**Fourth Contract**). Mr Smith signed the 'Deed of Agreement' on the understanding that he was a director of Zenith at the time he signed it.

(e) During the period between 3 and 12 August 2010, settlement of First to Fourth Contracts occurred.

(f) Zenith did not lodge an income tax return with the Commissioner in respect of any year following the year ended 30 June 2008. It entered into liquidation in 2013.

(g) In 2014, the taxpayer lodged its income tax return for the year ended 30 June 2011. The income tax return included $5,000,000 from the sale of the land in Astoria in assessable income.

The Commissioner issued an assessment to the taxpayer for the year ended 30 June 2011 on the basis that approximately $1,000,000 out of the $3,850,000 paid by ABC under the Fourth Contract was income derived by the taxpayer in connection with the sale of the three blocks of land in Astoria.

The Commissioner submitted that the Tribunal would not be satisfied that the taxpayer had discharged its onus of proving that it *derived* (within the meaning of ss 6-5(4) of the ITAA 1997) proceeds of no more than $5,000,000 (reflected on the face of the First, Second and Third Contracts) in respect of the sale of the land in Astoria. The Commissioner submitted that there was a clear commercial relationship between the transactions. Namely:

(a) the Fourth Contract was dated the **same date** as the Third Contract;

(b) the purchaser identified on the Fourth Contract was the **same purchaser** identified on the First, Second and Third Contracts;

(c) the subject matter of the Fourth Contract included *"development documents"* relating to the **same land** the subject of the First, Second and Third Contracts.

The Commissioner submitted that the explanation given by Mr Smith, the director of the taxpayer, in his affidavit was convoluted, did not make any sense commercially (or legally) and would not be accepted by the Tribunal.

Further, the Commissioner submitted that the fact that the taxpayer may not *itself* have *received payment* of an amount in excess of $5,000,000 is not to the point. He observed that: (a) ss 6-5(1) of the ITAA 1997 provides that a taxpayer's assessable income includes income according to ordinary concepts; and (b) ss 6-5(4) of the ITAA 1997 provides that in working out whether a taxpayer has "*derived an amount of ordinary income, and (if so) when [the taxpayer] derived it, [the taxpayer] is taken to have received the amount as soon as it is applied or dealt with in any way on [the taxpayer's] behalf or as [it] directs*".

The Commissioner submitted that the Tribunal would draw, with great confidence, the inference that at the time Mr Smith executed the Fourth Contract, the taxpayer impliedly directed that ABC make payment under the Fourth Contract in connection with the land in Astoria to Zenith for the following reasons:

(a) on its express terms, the Fourth Contract related to the development consent in connection with the land in Astoria;

(b) there was no dispute that as at 7 June 2010, the date of the Fourth Contract, the taxpayer continued to be the registered proprietor of the land in Astoria;

(c) pursuant to the Fourth Contract, ABC was required to pay $3,850,000 + GST to Zenith in relation to the D.A Documents (defined to include “council approvals” for the land in Astoria);

(d) having regard to the express terms of the Fourth Contract, the development consent for the land was sought to be sold:

   (i) by an entity (Zentih) in the taxpayer’s group that did not own the land; and

   (ii) to the entity (ABC) that was simultaneously in the process of acquiring the land from the taxpayer;

(e) ABC completed the transaction by paying Zenith $3,850,000 in accordance with the Fourth Contract; and

(f) at all material times, Mr Smith was the sole director of the taxpayer and he executed the Fourth Contract.

The Tribunal accepted that it was open for it to draw an inference that there was an implied direction from the taxpayer to ABC to pay Zenith that portion of the proceeds of sale under the Fourth Contract which related to the Astoria properties. The Tribunal found that the taxpayer did not establish the inference should not be drawn and it followed that it was therefore irrelevant that the taxpayer did not receive the funds itself. The Tribunal concluded that the portion of the sales proceeds under the Fourth Contract assessed by the Commissioner was derived by the taxpayer under s 6-5 of the ITAA 1997 even if it never actually received the monies into its accounts.

6. *Income derived* for the purposes of s 128B of the ITAA 1936

6.1 *PepsiCo, Inc v Commissioner of Taxation* [2024] FCAFC 86 (*PepsiCo, Inc*)

In *PepsiCo, Inc*, the Commissioner submitted that PepsiCo, Inc (**PepsiCo**) had "*derived income*" for the purposes of s 128B(2B)(a) of the ITAA 1936, notwithstanding the amounts in question had been *paid* to a different entity.

Section 128B(2B)(a) of the ITAA 1936 relevantly provides:

> "…this section applies to income that:
> (a) is derived by a non-resident…; and
> (b) consists of a royalty…"

The case concerned an arrangement under which Schweppes Australia Pty Ltd (**SAPL**) or the 'Bottler' purchased concentrate to make beverages from PepsiCo Bottling Singapore Pty Ltd (**PBS**) or the 'Seller'. While the case focused on whether the amount paid by the Bottler to the Seller included royalty components, an ancillary issue was whether any royalties were "*income derived*" by PepsiCo.

At first instance, Moshinsky J concluded that the payments made by the Bottler to the Seller included royalty components. His Honour also found that PepsiCo, as a party to the relevant agreement with SAPL, was entitled to receive payments made under the agreement even though it had nominated PBS as the seller of the concentrate. The Seller was not, and did not become, a party to the relevant agreements.

Accordingly, Moshinsky J found that by nominating the Seller under the agreements, PepsiCo directed that SAPL pay the Seller rather than PepsiCo (as applicable). In these circumstances, his Honour found that the relevant portions of those payments "*came home*" to PepsiCo (in the sense described by Dixon J in *Carden's Case*) by being applied as directed. The relevant portions were therefore "*income derived*" by PepsiCo for the purposes of ss 128B(2B)(a) of the ITAA 1936.

On appeal, the Full Federal Court concluded that the payments made by the Bottler to the Seller did not include any component which was a royalty as required by ss 128B(2B)(b) of the ITAA 1936. Accordingly, the Full Court found that the payments made to the Seller from the Bottler could not constitute "*income derived*" by PepsiCo within the meaning of s 128B(2B)(a) of the ITAA 1936.

While it was not strictly necessary for the Full Court to determine the "*income derived*" issue, the Court would have found there was no "*income derived*" in any event. That is, the contract under which the concentrate was sold provided that the concentrate would be sold be PepsiCo or a nominee. Once an alternative entity was nominated (i.e. the Seller) it became clear that entity was selling the concentrate and it was the seller who was entitled to the contract payment. Accordingly, there was no mechanism under which PepsiCo could have "*derived*" the income. The payments made by the Bottler to the Seller did not "*come home*" to PepsiCo in the sense described by Dixon J in *Carden's Case*.

Perram and Jackman JJ relevantly observed (at [40]):

> "It is well established that a direction by a creditor to a debtor to pay a third party constitutes a payment to the creditor…Nevertheless, it is also recognised that there can be no payment by direction unless there is an antecedent monetary obligation…"

On 8 August 2024, the Commissioner applied to the High Court for special leave to appeal from the whole of the PepsiCo judgment of the Full Court.

6.2 Beneficial entitlement to income for treaty purposes

Article 12 of the *OECD Model Convention on Income and Capital* is headed "Royalties" and relevantly provides:

> "1. Royalties arising in a Contracting State and **beneficially owned** by a resident of the other Contracting State shall be table only in that other State.
>
> …3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein and the right or property in respect of which the properties are paid is effectively connected with such permanent establishment. In such case, the provisions of Article 7 shall apply." (emphasis added).

The OECD Commentary on Article 12 concerning the taxation of royalties relevantly provides:

> "4. [The term 'beneficial owner'] The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the State of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance."

In Pepsi Co, Inc at first instance, Moshinsky J found that the PepsiCo, as a party to the agreement, was *beneficially entitled* to the relevant portion of the payments from SAPL within the meaning of Article 12 of the US DTA because PepsiCo was *"entitled to receive the payments under the EBAs and directed SAPL to pay PBS".*