1. INTRODUCTION

To the outside observer the idea of enacting an income tax act without a definition of "income" must appear inadequate. Of course it is not strictly correct that our income tax legislation contains no insight into the meaning of income as it is littered with specific statutory inclusions in income. However the central plank, namely “ordinary income”, is rather unhelpfully defined as "income according to ordinary concepts".\(^1\)

It has thus been left to the judiciary to determine the meaning of ordinary income. Much has been written on this quest.\(^2\)

Traditionally, the judiciary has turned to jurisprudential trust law principles for inspiration. Thus a distinction is made between income and capital and regard is had to the character of the receipt in the hands of the recipient or, in other words, the nature of the source which generates the receipt.

This typically necessitates a difficult factual analysis with the determination of income often falling on fine distinctions. A dichotomy is drawn between income sourced from personal services, property and business activities. These concepts of income are to be distinguished from a receipt arising from the disposal of a capital asset.

In determining whether a receipt is sourced from a business activity the judiciary have developed indicia to assist in identifying whether a business exists. Chief amongst these indicia are "frequency of transactions" and "profit-making purpose". Of

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\(^1\) Income Tax Assessment Act 1997 (Cth) ("ITAA97"), s 6-5.
course the judiciary have continually reiterated that
these indicia are only guides and none are determi-
native. Conversely, it is not necessary for all the
indicia to exist for the conclusion that a receipt is
sourced from a business.

Notwithstanding this, there was an initial judi-
cial reluctance to acknowledge as income a receipt
from a one-off transaction, albeit entered into with
a profit-making purpose.\(^3\) The Australian legisla-
ture responded with an amendment specifically
including in assessable income a receipt from the
disposal of property acquired with the intention of
profit-making or ventured into a profit-making
undertaking.\(^4\)

However, by this stage the income capital
dichotomy had been well established by the judi-
ciary and it was necessary to reconcile it with this
new provision. The attempted reconciliation was
the mere realisation doctrine. That is, if an asset
was simply disposed of or realised then the receipt
was a capital gain and not income.

This reconciliation, however, generated the
finest of factual distinctions. It was not unreason-
able to expect an owner of an asset to attempt to
realise it in the most profitable manner. So the judi-
ciary had to deliberate on when a realisation was
simply a "mere realisation in a most advantageous
manner" and when it crossed the boundary into the
venturing into of a profit-making undertaking or
scheme.

Tangential with this development was a growing
concern amongst commentators that the judicial
definition of income was misguided. It was argued
that the economic theory upon which our income
tax laws were based was that taxpayers were to be
taxed according to increments in their well-being
or, more crudely, on their gains. This notion of gain
knew no distinction between income or capital.\(^5\)
Thus, it was not necessary to examine the receipt in
terms of its character to the recipient nor embark
upon any analysis of the source from which the
receipt flowed. This can be referred to as the "gain
theory of income".

However, the judiciary has resisted embracing
this view probably partly because the source/flow
approach is so well entrenched and also partly
because, in its most purest form, there is concern
over the practical implementation of the gain theo-
y of income.\(^6\)

Nevertheless, most recently the judiciary, possi-
bly influenced by the legislative resolve to tax
capital gains, and possibly concerned at the very
fine distinctions that were determining the assess-
ability of a receipt, have begun to embrace
elements of the gain approach.

No more evident is this than the retreat from
the mere realisation principle by the High Court in
Whitfords Beach Pty Ltd v FC of T\(^7\) and FC of T v
Myer Emporium Ltd.\(^8\)

The propositions established by these two cases
are well known. Essentially an extraordinary trans-
action entered into by a business will give rise to
ordinary income where the transaction is commer-
cial in nature and entered into for the purpose of
profit-making by the means giving rise to the prof-
it.\(^9\) Additionally, by way of expansion of the
business source category of income, Myer has also
been interpreted as holding that receipts, not
derived in the ordinary course of business but inci-
dental to the business activities, are income.\(^10\)

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\(^3\) For example, see Jones v Leeming [1930] AC 415 and Ruhamah Property Co v FC of T (1928) 41 CLR 148.
\(^4\) It became s 25A of the Income Tax Assessment Act 1936 (Cth) ("ITAA36").
\(^5\) See, for example, R Parsons, "Income Taxation - An Institution In Decay" (1986) 3 Australian Tax Forum 233. In addition, in
its purest form, this theory draws no distinction between realised and unrealised gains.
\(^6\) See the concise analysis of the contrast in the imprecise economic approach and the legal quest for certainty in Lehmann &
\(^7\) (1982) 150 CLR 355; 82 ATC 4013; 83 ATC 4277 ("Whitfords Beach").
\(^8\) (1987) 163 CLR 199 ("Myer").
\(^9\) Ibid 210 - 213.
\(^10\) FC of T v Cooling 90 ATC 4472 ("Cooling").
As is often a phenomenon with perceived radical decisions, there was, subsequent to Myer, some retreat from the potential width of these propositions. Thus, in FC of T v Spedley Securities Ltd\textsuperscript{11} the Full Federal Court reiterated that the decision did not mean that all receipts received by a business were income.\textsuperscript{12} Additionally, the first proposition was further restricted with the addition of the requirement that the asset disposed of have been acquired with a purpose of profit-making by the very means by which the profit was in fact made.\textsuperscript{13}

However not every subsequent decision was restrictive. Probably the high water mark to date of the application of Myer was the first decision dealing with the assessability of lease incentives, FC of T v Cooling.\textsuperscript{14}

It will be argued below that this decision and, even more so, the subsequent cases on lease incentives which have sought to distinguish it, reveal the strongest indication yet that the judiciary is more prepared to approach the identification of income in terms of whether the taxpayer has made a gain.

Prior to examining these decisions, it is appropriate to identify the background in which the lease incentive cases were decided.

2. BACKGROUND TO THE LEASE INCENTIVE CASES

The oversupply of commercial rental property during the 1980's witnessed the rise in popularity of lease inducement incentives. Prestigious tenants where able to obtain very attractive incentives. Notably, these incentives seldom included a reduction in rent (other than a temporary rental holiday) as lower rent would reduce the capitalised value of the property which, particularly in the case of superannuation fund lessors, was undesirable.

2.1 Types of Lease Incentives

Four types of lease incentives were common:

1. Cash payments with no attendant obligations on the lessee, in particular no restrictions on how the funds could be expended.
2. Rent free periods or rent discounts/subsidies. For the reasons stated above, these were structured in such a way that the rent payable under the lease agreement remained at or above market value.\textsuperscript{15}
3. Interest free loans.
4. Free fit-outs whether paid directly by the lessor or by way of reimbursement of the lessee for fit-out expenses. Whilst, by virtue of the doctrine of fixtures, ownership of the fit-out would vest in the lessor, the lessee might be provided with a right of removal at the expiration of the lease.

Initially, cash payments were viewed as the most attractive form of lease incentive given the flexibility as to the application of the proceeds. Additionally, no potential tax deductions were lost by the lessee and, on the understanding that the inducement payment was in the nature of a negative premium, it was a payment on capital account and hence not assessable.

In fact, apart from the possibility of the reimbursement provisions\textsuperscript{16} applying, then later possibly Pt IVA of the ITAA36,\textsuperscript{17} there appeared to be little risk of the lease inducement being assessable. Even with the introduction of Pt IIIA of the

\textsuperscript{11} 88 ATC 4126.
\textsuperscript{12} Also see Moana Sands Pty Ltd v FC of T 88 ATC 4897.
\textsuperscript{13} Westfield Ltd v FC of T 91 ATC 4234.
\textsuperscript{14} 90 ATC 4472.
\textsuperscript{15} Typically any references to rent holidays or subsidies were restricted to collateral documentation.
\textsuperscript{16} ITAA36, Subdiv D of Div 3 of Pt III. The effect of these provisions applying would be to deny a deduction for the rent.
\textsuperscript{17} Whist enacted in 1981, it was not until the late 1980s that the Commissioner began to actively apply this Part.
ITAA36 in 1985, it remained inconceivable that an inducement could be assessable in the absence of the disposal of an asset by the lessee. The prevailing view amongst professional advisers at that time was that s 160M(7) of the ITAA36 would have to be read narrowly. In the event, although the matter went to the wire, the view prevailed that s 160M(7) had no application to cash receipts in the absence of an asset owned by the recipient (and not any party) being affected.19

However, developments came from unexpected sources in the form of the decision of the High Court in Myer. The opportunity thereby provided for a reconsideration of the scope of the concept of income was taken up in Cooling.20

3. FC OF TV COOLING

The decision of the Full Federal Court in Cooling concerned a Brisbane law firm that had been approached by AMP to relocate to new premises. An option of a cash incentive or a rent holiday was offered. Whilst the solicitors were reluctant to move they were swayed by the offer and took up the cash incentive which was paid directly to them, although the lease was taken up by their service company.

In the event, the partners applied the proceeds of the cash payment to fit-out expenses although they were not required to do so under the terms of the payment. Once the fit-out was complete, it was sold to a financier and leased back.

The principal judgment of the court was delivered by Hill J. His Honour found that a profit-making purpose was "a not insignificant" purpose of the whole arrangement and so, on the authority of Myer, the amount was assessable. 18

Notably, given his Honour's recent decision in Lees & Leech Pty Ltd v FC of T,21 Hill J did not embark on any analysis as to whether the partnership made a gain arising from the lease incentive payment. It is submitted that whether a gain was made depended upon the price for which the fit-out was sold to the financier, namely whether it was for the full cost of the fit-out or a net amount taking into account the lease incentive payment. Whilst the facts are silent on this point, the decision is consistent with the assumption that the fit-out was disposed of at its gross cost thereby providing the partners with a gain.

It is suggested that much significance can be placed on that part of the judgment where Hill J argues that the decision accorded with common-sense because the firm had the option of paying less rent and therefore obtaining a smaller tax deduction or paying a higher rent and obtaining a larger tax deduction but receiving a cash payment in the form of assessable income.22 Clearly, his Honour was concerned with the symmetry aspect. Certainly on the grounds of equity, no issue can be taken with the judgment on this point.

Two other aspects of the judgment have proved to be much more controversial.

Firstly, in distinguishing the payment from a premium received by a lessor, his Honour referred to the fact that a lessor is receiving the payment for the grant of a leasehold estate whereas a lessee in receipt of an incentive payment is not parting with an estate in land. Therefore, no analogy could be drawn.

Most controversial however is the following statement from the judgement:

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18 This provision deems an asset to have been disposed of where there is an act, transaction or event in relation to an asset as a result of which the taxpayer receives consideration.
19 See Hepples v FC of T 91 ATC 4808 as interpreted in Callow v FC of T 97 ATC 4350. Also see Paykel v FC of T 94 ATC 4176. The provision was subsequently amended to reflect this view.
20 90 ATC 4472.
21 97 ATC 4407 ("Lees & Leech").
22 This supports the assumption raised in the preceding paragraph as the disposal of the fit-out at gross cost would provide the partnership with higher lease/finance charges and hence a greater tax deduction.
"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 just as much as the trading activities that give rise more directly to the taxpayer's assessable income." 23

Whilst the bulk of the judgment could readily be characterised as simply an application of Myer to the facts, this statement had the hallmarks of a new principle.

4. THE AFTERMATH OF COOLING

Following this decision, there was a scramble by lessees to distance the receipt of lease inducements from the facts of Cooling and to identify what tax effective forms of lease inducements remained.

4.1 Rent Holidays and Discounts

Whilst rent holidays and discounts would appear to have been unaffected by the decision, these lacked the tax advantages that cash payments hitherto had. In addition, the much awaited enactment of s 21A of the ITAA36 in late 198824 raised the possibility that the value of the rent holiday or discount might be assessable as a non-cash business benefit. Whilst s 21A was predicated on the non-cash business benefit being in the nature of income, the Commissioner was now taking a very broad view as to income and in Income Taxation Ruling IT 2631, stated that such discounts and holidays were only non-assessable due to the operation of the "otherwise deductible rule" in s 21A(3). However, this rule was restricted to "once only" deductions and there was a fear that rent payments might not be viewed as discrete one-off payments, especially given the possible application of s 82KZM of the ITAA36.25

Arguably, however, the application of s 21A(3) was never truly an issue as it was difficult to conceptualise, on the case law existing at the time, of a rent discount or holiday as income given that nothing had "come in" the hands of the taxpayer.26 However, recently in Warner Music Australia Pty Ltd v FC of T,27 Hill J stated that, at least in relation to continuing businesses required to account on an accruals basis, income was not confined to that which comes in. His Honour accepted that gains, which were at least capable of being converted into money,28 might constitute income. Accordingly, his Honour held that a reduction in a sales tax liability amounted to assessable income. There was clearly a gain29 and the liability to sales tax was an ordinary incident of the taxpayer's income-producing activities.

It is a small step to extend this analysis to the circumstances of a rental holiday or discount. Clearly, there was a gain to the lessee. Then, if the "comes in" criterion is dispensed with, as the liability to rent would be an ordinary incident of a lessee's business activities, the gain would be in the nature of income. Any "conversion" difficulties are then dealt with by s 21A.

In the absence of any difficulties satisfying the "come in" criterion, it is even conceivable that rent holidays or discounts might give rise to income within the ordinary meaning of the concept without

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23 90 ATC 4472, 4484.
24 This was the legislative response to FC of T v Cooke & Sherden 80 ATC 4140.
25 Where the holiday/discount related to a period in excess of 13 months (ITAA36, s 82KZM renders certain prepayments deductible over time.).
26 See Tennant v Smith (1892) AC 150 at 164; Squatting Investment Company Ltd v FC of T (1953) 86 CLR 570, 627–628; FC of T v Cooke & Sherden 80 ATC 4140, 4149. Arguably decisions such as International Nickel Australia Ltd v FC of T (1977) 137 CLR 347 and Mutual Acceptance Ltd v FC of T 84 ATC 4831 were distinguishable on their facts.
27 96 ATC 5046 ("Warner Music Australia").
28 His Honour did not elaborate on this statement and clearly did not see it as an issue on the facts. Arguably s 21A should supply any deficiency.
29 This is difficult to reconcile with the lease incentive decisions discussed below, especially his Honour's own decision in Lees & Leech. In both cases, there was a reimbursement of an outgoing. It is suggested that this supports the proposition enunciated below that the unstated rationale for the differing decisions on lease incentives is an attempt to maintain symmetry in terms of the tax position of the lessee.
recourse to s 21A. Where a lease does not contain a covenant against assignment or sub-lease then arguably the rent free period would be convertible into cash. In any event, such clauses are construed strictly against the lessor and it is normally possible for the lessee to enter into a valid sub-lease or license and the lessor is merely left with a remedy in contract against the lessee. The issue depends upon whether the lease contains a right of re-entry in the event of breach of the covenant against sub-letting of assignment. If not, then the argument that the rent holiday gives rise to income according to general principles gains strength. Of course, assessability under s 6-5 of the ITAA97 would deny recourse to the otherwise deductible rule in s 21A(3).

The inequity with such a conclusion is that it would be most improbable that the lessee would have claimed a deduction for the rent foregone. In this respect, the decision in Warner Music Australia can be distinguished. The difficulty, however, is that Hill J expressly rejected any principle that a gain was income just because it had its origin in the refund of a previous amount that had attracted a deduction. The assessability of the refund was not to be predicated on the deductibility of the initial outgoing.

It is notable that Warner Music Australia is the most recent decision in a series of cases, extending the principle that income need not “come in”. Originally, these decisions were almost universally restricted to cases involving foreign currency exchange movements. More recently, this was recognised in relation to debt defeasance arrangements. It is suggested that the recent extension of this principle in Warner Music Australia brings the decision into direct conflict with the traditional view that income is what comes in, it is not what is saved from going out. It also provides further support for the view expressed below that the gains analysis is infiltrating the application of the traditional principles of income determination.

4.2 Cash Payments and Free Fit-outs

Most attention post Cooling however turned to cash payments and free fit-outs. One possibility that was explored was tying any cash incentive payment to expenditure to be incurred by the lessee. That is, the view was taken that a reimbursement payment ought not be viewed as being derived with a profit-making purpose. Alternatively, there would be no profit or gain which could be tainted with such a purpose.

Whether the reimbursement had to be in respect of non-deductible (or non-deducted) expenses was a matter of some conjecture. The conservative view was that although there was no principle that the reimbursement of capital expenditure would necessarily be on capital account, any amounts reimbursed should be non-deductible capital expenditure.

Of course, where the expenditure reimbursed was fit-out expenses, the fit-out would have been

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31 Massart v Blight (1951) 82 CLR 423.
32 Could the lessee nevertheless claim a deduction for the rent and thereby achieve symmetry? Circumstances could be envisaged where the rent holiday was structured in such a way as to achieve a deduction for the lessee. What if there was a refund agreement? However, following the lease incentive decisions discussed below, there would be no gain to the taxpayer in such circumstances and therefore no assessable income, although it is argued that the impetus for this finding is lost should the lessee have claimed a tax deduction for the rent.
33 An income tax deduction had been claimed for the sales tax.
34 Following the Full Federal Court decision in FC of T v Rowe (1995) 60 FCR 90.
35 For example, see International Nickel Australia Ltd v FC of T (1977) 137 CLR 347 (“International Nickel”).
36 ICI Australia Ltd v FC of T (1996) 4680.
37 See the cases referred to in above n 27.
38 In fact in GP International Pipeloaters Pty Ltd v FC of T (1990) 170 CLR 124; 90 ATC 4413 (“GP International Pipeloaters”) reimbursement for capital expenditure was held to be on revenue account.
39 Not private expenditure.
depreciable.\(^{40}\) The conservative view was that provided only depreciation was claimed on the net cost, then there would be no loss to the revenue and the ATO would be unlikely to argue that the reimbursement was assessable.

Unfortunately in IT 2631, the Commissioner's analysis of free fit-outs is couched in terms of whether ownership has passed to the lessee. Where ownership has passed, the ruling argues that the value of the fit-out constitutes income. In such a case, whilst the fit-out would not be convertible to cash, s 21A will apply (without recourse to s 21A(3) as there would not be a "once only" deduction to the lessee). As the fit-out will, in most cases, constitute fixtures owned by the lessor, then the lessee's "ownership" will derive from its right to remove the fit-out at the expiration of the lease. The ruling argues that for the purposes of s 21A the value of this interest is considered the cost of the fit-out, with no discount for the fact that the fittings were likely to be worth much less than their cost upon removal. However, the lessee would be entitled to claim depreciation in most cases.

The ruling rejects the reimbursement argument. Where a lessee pays for a fit-out after receiving the cash incentive from the lessor, the full value of the incentive is assessable. No comment is ventured about the situation if the lessee was contractually bound to apply the incentive to the fit-out.

Curiously, the ruling provides that if the lessor paid for the fit-out out of a cash lease incentive and only the balance after payment of the fit-out was forwarded to the lessee, then only that balance would be assessable income.\(^{41}\) On the other hand, direct payment by the lessor to the contractor on behalf of the lessee would result in an assessable amount to the lessee by virtue of the constructive receipt provisions in s 6–5(4) of the ITAA97.\(^{42}\)

The ruling also provides that, amongst other things, the payment of removal expenses or surrender payments by the lessor, would be assessable to the lessee. Given that both these expenses traditionally are viewed as non-deductible to the lessee this would, at least in the Commissioner's view, appear to define the limits of the commonsense symmetry proposition enunciated by Hill J.\(^{43}\)

Finally, the ruling at para 10, states that an incentive payment to a taxpayer to commence an entirely new business is not income. This curious concession is explained on the basis that the Commissioner took the view that s 160M(7) would catch the amount in such a case. However, of course, the ruling pre-dated Callow v FC of T\(^{44}\) and the amendment to the provision which renders it difficult to identify how such a payment would constitute an assessable capital gain.\(^{45}\)

5. LEASE INCENTIVE CASES SINCE COOLING

Whilst Cooling embraces a broad notion of business income, it is unremarkable in terms of its analysis. This analysis is consistent with the traditional view that income is to be identified from the nature of the source from which a receipt flows and there is no consideration in the judgment of whether a gain was in fact made. However, it is the decisions on lease incentives subsequent to Cooling

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\(^{40}\) Whilst under the law as it stood at the time, the tenant was not technically entitled to claim depreciation, not being the owner of the fixtures, this was permitted by virtue of the Commissioner's fiat. See Income Taxation Ruling IT 175. Query what was the depreciable cost of the fit-out?

\(^{41}\) Presumably the ATO is assuming that the lessee will not be depreciating the fittings.

\(^{42}\) An addendum qualified this to be only in circumstances where ownership of the fit-out passed to the lessee and the lessee had contracted with the contractor.

\(^{43}\) On the face of it, the logical hiatus is compounded by the fact that the ruling provides that holiday packages do not give rise to assessable income because they are specifically made non-deductible to the lessor. Presumably the Commissioner would argue that symmetry is maintained as the lessor is obtaining a deduction in the case of the reimbursement of removal expenses and surrender payments.

\(^{44}\) 97 ATC 4350.

\(^{45}\) As no asset of the lessee is involved.
which most emphatically embrace the gain analysis. It is ironic that this analysis is embraced with the aim of distinguishing the facts from Cooling and thereupon finding that an incentive is not income.

5.1 Lees & Leech Pty Ltd v FC of T

This decision of Hill J was the first indication that his Honour's judgment in Cooling may have been read too broadly.

The lessee had received a payment of $40,000 from the lessor by way of contribution to the $90,000 fit-out expenses of a new shop leased in the Australia Fair complex on the Gold Coast. The fit-out was organised by the lessee and they had a right to remove the fittings on expiration of the lease. The Commissioner sought to assess the lessee in purported application of the ruling.

Hill J held that the amount was not assessable. Any ownership rights that the lessee had in the fittings by virtue of its right of removal had a nominal cash value under s 21A. Thus, there was no profit or gain to the lessee and hence there could be no profit-making purpose.

Additionally, whilst noting the warning in GP International Pipecoaters Pty Ltd v FC of T about characterising receipts by reference to their application, his Honour stated this was simply a reimbursement of a capital expense and not a cash incentive to be characterised.

Comparing this decision to that of his Honour in Cooling, there would appear to be an implied distinction between the professional firm in Cooling and this retailer in that presumably in the case of the latter it is not the case that "the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to its income." This was so notwithstanding that the evidence was that the lessee had a number of businesses operating from leased premises across Australia.

Finding that the lessee had not made a gain is also difficult to reconcile with Cooling where the lessor's contribution was also applied to fit-out expenses. The only obvious grounds for distinguishing the two situations is that in Cooling there was then a sale and leaseback of the fittings and the partners were not under a contractual obligation to use the funds for fit-out purposes. However, it is submitted that neither of these factual differences is adequate justification for the finding of a gain in Cooling and not in Lees & Leech.

It is suggested that a possible rationale for the difference in the two decisions is that the lessee in Lees & Leech only depreciated the net fit-out expenses after deduction of the lessor's contribution. Thus, symmetry was maintained by holding the contribution non-assessable and commonsense prevailed.

5.2 Selleck v FC of T

The merger of two Melbourne law firms necessitated the leasing of new premises. A lease was entered into with AMP with the new law firm electing to take as a lease incentive a contribution of $1 million to fit-out expenses rather than a six month rent free period. The firm was contractually bound to apply the payment to fit-out expenses. Upon completion of the subsequent fit-out, which cost $2.5 million, the fit-out was sold for $1.5 million to

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46 The first decision on lease incentives post Cooling was Rotherwood Pty Ltd v FC of T 96 ATC 4203. Whilst the decision did not consider the gain approach to income, it concerned unusual facts and the most that can be said is that it continued the Cooling theme of an expansive approach to the meaning of business, in this case the business of a service trust.

47 (1990) 170 CLR 124; 90 ATC 4413.

48 Cooling 90 ATC 4472, 4484.

49 Depreciation was claimed pursuant to the Commissioner's rulings in IT 175 and IT 2631. It is inherent in the decision in Cooling that the fit-out was sold to the financier at its gross cost thereby resulting in higher lease/finance charges and hence a greater tax deduction.

50 97 ATC 4856 ("Selleck").
a financier and leased back. There was no immediate cash payment back to the partners but rather the payment from AMP was credited to a suspense account and appropriated to the partners over the period of the lease. The evidence was that the incentive payment had very little influence on the decision to accept the lease.

The Full Federal Court unanimously held that the $1 million was not assessable.

Lockhart J, with whom Black CJ concurred, was swayed by the fact that in determining the true character of the money received, this was a new firm created by a merger. The firm was effectively compelled to find new premises, unlike in *Cooling*, and the incentive payment was made to the firm, not to the individual partners. Here the incentive payment was not a major influence on the leasing decision and in the circumstances the firm did not have any profit-making purpose.

Beaumont J took a similar approach to Hill J in *Lees & Leech* concluding that there was no profit, only a shortfall of $1.5 million and thus there was no profit-making purpose. His Honour did not see any difficulty in this analysis presented by the decision in *GP International Pipecoaters*.

In his Honour's view, lease incentive payments are prima facie on capital account being in the nature of negative premiums. On this point he expressly disagreed with the distinction drawn by Hill J in *Cooling* between the acquisition and disposal of a leasehold estate.

His Honour drew an analogy between the payment received by the firm to only deal with this landlord and a trade tie payment received by a trader to restrict their dealings to one supplier. Arguably, this analogy requires a very broad view of the notion of a trade tie. For it to be maintained, presumably, although it is not clear from the facts, the lease was non-assessable.

Importantly, to his Honour there was no attempt to generate a cash distribution back to the partners by selling the fit-out for its gross cost. The proceeds of the sale and leaseback were applied to business ends and were not distributed to the partners. The fact that the accounting treatment of the inducement payment was to credit it to a suspense account and appropriate it to the partners over 10 years was irrelevant.

It is suggested that inherently his Honour was also swayed by the maintenance of symmetry in that by effecting the sale and leaseback at net cost, the firm was not attempting to achieve a tax deduction for that part of the fit-out expenses that had been reimbursed.

5.3 *Montgomery v FC of T* 51

As an inducement for a Melbourne law firm to relocate to new premises it received an incentive payment of $29 million. These monies were to be drawn down for payment of specified expenditure such as fit-out expenses, stamp duty, early termination penalties and legal expenses. 52

Whilst refurbishment work at the firm's existing leased premises rendered the idea of relocation more attractive, there was no suggestion that the firm was compelled to relocate.

The Full Federal Court unanimously held that the payment was on capital account and not assessable. Heerey J agreed with Beaumont J in *Selleck* to the effect that lease incentive payments were prima facie on capital account. It appears that his Honour was prepared to overrule *Cooling* which he interpreted as suggesting that incentives were always income. His Honour expressly disagreed with the distinction drawn between premiums and incentive payments.

51 98 ATC 4120 ("Montgomery")
52 In the judgments of *Lees & Leech* and *Selleck*, their Honours interpreted the facts of *Montgomery* as there being no caveat on what this $29 million could be expended on.
Additionally, his Honour took the view that there was no gain derived by the lessee to which any profit-making purpose could attach.

Also no distinction was to be drawn between existing firms relocating and a new firm entering into a lease for the first time. In this respect his Honour expressed disagreement with Selleck, although, with respect, the Court in Selleck placed little weight on this matter.

His Honour also stated that there was no distinction to be drawn between circumstances where a lessee was compelled to move and one where the decision was voluntary as in Cooling.

Finally his Honour expressed agreement with the New Zealand Court of Appeal in Wattie v Commissioner of Inland Revenue53 stating that the business of the law firm could not sensibly be said to be or include dealing with leaseholds simply because it was obliged to have rental accommodation.

Davies J came to a similar conclusion that there was no profit54 having regard to the lessee's obligation under its existing lease, its fit-out expenses, the relocation expenses and the higher new rental obligations.

His Honour contrasted Cooling on the basis that in that case, the payment was to the partners, an option for a lower rental payment in lieu of a lease incentive had been offered and it had not been essential to move, unlike on the facts before his Honour which he interpreted as generating a commercial necessity to move.

Lockhart J distinguished Cooling on a similar basis adding that there was no merger or refurbishment of the existing premises in that case and the incentive influenced the decision to a "not insignificant degree". Whilst his Honour left open the issue of whether the profit-making purpose had to be dominant or merely significant he concluded that there was no profit-making purpose on the facts as the lessee's purpose in entering into the lease was simply to obtain prestigious premises.

Although his Honour conceded that the capital sum would filter through to the partners over a period of time, initially it was used to pay expenses some of which were deductible (but not claimed) and some which were not. It is suggested that his Honour was inherently impressed with the fact that no deduction had been claimed in relation to these expenses and thus symmetry ought be maintained. In fact, one of the matters before the Court was a claim for a deduction in relation to these expenses should the inducement payment be held to be assessable income.

This recognition that there was no initial gain to the partners but there would be over a period of time is indicative of an inherent dilemma in the gain analysis. How is the existence of a gain to be determined? Is it sufficient to merely ascertain whether the receipt was applied to a business end and if so there was no gain? Alternatively is a tracing exercise required to determine whether ultimately the benefit washes out in the form of a return to the underlying proprietors?

5.4 Wattie v Commissioner of Inland Revenue

In return for relocating to new premises the accounting firm Coopers & Lybrand received a number of inducements including a rent subsidy, fit-out contributions and a $5 million cash payment. The sole issue was the assessability of the cash payment.

The lessee was under no obligation to apply the cash payment to any particular expenses although it was, in fact, offset against moving expenses in the firm's accounts with the balance allocated to the partners. Deductions for these moving expenses were claimed.

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53 (1997) 18 NZTC 13297 ("Wattie").
54 Curiously his Honour considered that there was a gain but no profit.
By a majority of 4 to 1, the New Zealand Court of Appeal held that the cash payment was not assessable. In so finding, the Court rejected the finding in *Cooling* that there is a distinction between incentives and premiums and that the business of a professional firm which leases business premises includes the re-negotiation of leases. This was so notwithstanding that Coopers & Lybrand leased 15 premises in New Zealand and that 1 to 2 leases had to be re-negotiated each year. The only exception to this principle that their Honours were prepared to recognise was if a lessee had captured a number of lease incentive payments in the past.\(^{55}\)

Their Honours stated that there was no gain here from an adventure in the nature of trade. Whilst not expanding on the point their Honours suggested that there was probably no gain at all derived by the lessee. In dissent, Thomas J emphasised the commercial reality of the matter in that the incentive payments were reflected in a higher than market rent being paid by Coopers & Lybrand. His Honour saw the inducement payments as part of a rent reduction and therefore, to be properly treated as income. Of significance was the fact that the full inflated rent was being claimed as a tax deduction.

His Honour referred to the principle that a premium is normally not on capital account where the related rental payments are greater than market value.

Additionally, his Honour rejected any notion that this payment was a reimbursement for capital expenses and therefore, on capital account or analogous to a receipt in respect to a trade tie.\(^{56}\)

### 6. RECONCILING THE DECISIONS AND PERPETUATING A TRAVESTY

Whilst *Cooling* was initially viewed as ending tax effective incentive payments, the simple expedient of connecting the incentive payment with an anticipated outgoing of the lessee has caused the courts to retreat from the proposition that all lease incentives are assessable. Although the decisions subsequent to *Cooling* have struggled to identify rational points of distinction, the essential difference between the cases is that in *Cooling* the partners effectively claimed a tax deduction for expenditure for which they had been reimbursed whereas in *Lees & Leech, Selleck* and *Montgomery* the lessees were careful not to have it both ways.\(^{57}\)

Nevertheless, this generated a conundrum for the courts in that they were confronted with the principle in *GP International Pipecoaters* to the effect that it is not permissible to look to the application of a receipt in order to characterise whether the receipt is on capital or revenue account.\(^{58}\)

However, *GP International Pipecoaters* said nothing about whether it was permissible to examine the application of a receipt to determine whether a gain had, in fact, been made. Therefore, the manner in which the courts have been able to avoid the principle in *GP International Pipecoaters* is by the sleight of hand that, after examining the application of the receipt, there is found to be no gain and, thus, nothing to which a profit-making purpose can attach.\(^{59}\)

That is, although in analysing the character of a receipt, it is impermissible to look at the expenditure of the funds. On the other hand, in identifying whether a profit exists, this is a critical consideration. The opportunity for this

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55. This exception appears to be a hangover from the old principle that income exhibits periodicity.

56. His Honour found some support for his views in the Canadian decision of *IBM Canada Ltd v Minister of National Revenue* [1932] 2 CTC 2860.

57. This is supported by the analysis of *Warner Music Australia*. See footnote 29. There a deduction had been claimed for a sales tax liability providing an unacknowledged impetus for his Honour to hold that the reduction in the liability was an assessable gain.

58. This was only recently confirmed by the High Court in *FC of T v Rowe* 97 ATC 4317 ("Rowe"), where it was held that there was no general principle that an amount received by way of reimbursement of a deductible expense is income. Their Honours stated that whilst this created a lack of symmetry, there was precedent for this in the form of the *GP International Pipecoaters* case which in their view established the proposition that a receipt may be income in the hands of a payee albeit expenditure of a capital nature by the payer.

59. Contrast *Warner Music Australia* where Hill J embraced the principle in Rowe, yet was prepared to conclude that a gain had been made upon the reduction of a liability. Notably a tax deduction for the liability had been claimed.
sleight of hand to occur arises out of an inherent contradiction within the ITAA36 which Professor Parsons often complained about. That is, the concepts of income and profit are inappropriately inter-meddled.\(^{60}\)

This anomaly had been sharply brought into focus with the relationship between s 25(1) and s 25A of the ITAA36. Section 25A and its predecessors expressly included profit arising from the sale of property acquired with a profit-making purpose or from carrying out a profit-making scheme within s 25(1), assessable income.\(^{61}\) Subsequently, the inclusion of profits within s 25(1), ordinary income became clearly established with the decisions in *Whitfords Beach* and *Myer*. Unfortunately, the High Court chose to embrace the wording of s 25A\(^{62}\) in defining the concept of income according to ordinary concepts. As Waincymer observes,\(^{63}\) the effect of *Whitfords Beach* and *Myer* was to redirect the analysis back into s 25(1) and away from s 25A.

Of course, this had the effect of including profit as income under s 25(1) notwithstanding the reference therein to "gross income" and the existence of s 51(1) of the ITAA36 and the other deduction provisions.\(^{64}\) It also had the effect of ensuring that this anomaly would be preserved in our new income tax act.\(^{65}\)

**7. AN AMALGAM OF THE GAIN AND FLOW APPROACHES**

Another way of characterising this development is to argue that the judiciary has approached the issue on the basis of an amalgam of the economic gain and traditional flow approaches to defining income. Whilst on one hand the analysis examines the relationship between the derivation of the incentive and the taxpayer's business, the analysis also extends to whether a gain was in fact made. The opportunity to examine the issue in terms of whether a gain or profit exists arises from the courts' preoccupation with identifying the profit-making purpose indicator of income. In criticising the difficulties with the purpose indicator, commentators such as Waincymer and Parsons argue in favour of a re-definition of the concept of income to embrace the economic notion of a gain.

Whilst there is considerable merit in their arguments, reconceptualising income as a gain will not resolve cases such as *Selleck*, *Montgomery* and *Lees & Leech* but simply alter the focus. In determining whether a gain exists, ought the inquiry just be as to the immediate application of the funds or is it necessary to trace through to determine whether there was any ultimate return to the business proprietors? Additionally, is the ascertainment and calculation of the amount of a gain to be determined by accounting, economic or taxation principles?

The decisions in *Lees & Leech*, *Selleck*, *Montgomery* and *Wattie* all stop at the initial application of the funds and conclude that there was no gain. The judgments of Beaumont J in *Selleck* and Lockhart J in *Montgomery* reflect an appreciation of the issue but in each case it is avoided. Beaumont J concludes that whilst there ultimately was a return to the partners the intention underlying the transaction was not to generate this return. Lockhart J states simply that it is the initial application of the funds that is at issue. On the other hand, a concern that the partners were ultimately obtaining a return from the payment appears to have influenced the dissenting judgment of Thomas J in *Wattie*.

This illustrates that it is incumbent upon the proponents of the gain approach to the concept of income to explain how the existence and quantum

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\(^{60}\) Income is a flow. Profit is a result. See, for example, Parsons, above n 5.

\(^{61}\) Now perpetuated by ITAA97, ss 15–15 and 6–5.

\(^{62}\) Itself derived from cases concerned with profit, primarily *Californian Copper Syndicate v Harris* (1904) TC 159 and *Jones v Leeming* [1930] AC 415.

\(^{63}\) The problems inherent in this indicator of income have been examined in detail elsewhere; J Waincymer, "If at First You Don't Succeed ... Reconceptionalise the Income Concept in the Tax Arena" (1994) 19 MULR 977.

\(^{64}\) Which in turn created difficulties in relation to double deductions and appropriate timing rules. All this was compounded by the inclusion of capital gains into s 25(1) assessable income prompting Professor Parsons to refer to the income tax system as decaying.

\(^{65}\) ITAA36, s 25(1) is replaced by ITAA97, ss 6–5.
of an assessable gain is to be determined? Additionally, how are expenses to be treated? Would there be scope for the operation of s 8-1 of the ITAA97 and the specific deduction provisions? Alternatively would the ascertainment and calculation of the amount of a gain be left to general accounting or economic principles with the attendant uncertainty. It is one thing to argue that income ought to be defined in terms of a gain, but as these lease incentive decisions illustrate, it is then necessary to grapple with identifying the existence and quantification of the gain.

8. WHEN IS THERE A GAIN?

On one view, if a tracing exercise is appropriate to determine whether ultimately a benefit devolves to the proprietors, then it may be but a small step to conclude that all receipts would give rise to a gain. The inquiry is then simply back to where it started, namely whether this was the purpose or intention behind the transaction.

On the other hand, the notion that if there is no gain then there is no income was referred to by Parsons in his proposition 7 as the "Contribution to Capital" rule. That is, a contribution to capital which generated no gain to the taxpayer would not be income. In support of this principle, Parsons refers to a number of UK decisions which suggest that where money is received subject to an obligation to apply it to capital expenditure then it is not income. Parsons suggests that in the absence of such an obligation, the money would be on revenue account but even where it was subject to such an obligation, it would still be on revenue account where the capital expenditure increased the value of the taxpayer's property.

Parsons emphasises that the recoupment is not income because there is no gain so the issue of the deductibility of the recouped cost is irrelevant. However, in proposition 15, he states the "Compensation Principle" namely that a receipt which is compensation for, inter alia, an item that has the character of the cost of deriving income is itself income. Whilst he acknowledges the High Court decision in *HR Sinclair & Son Pty Ltd v FC of T* which decided that there was no principle that a refund of an amount that was an allowable deduction is income, he refers to the decision in *International Nickel Australia Ltd v FC of T* dealing with exchange gains and losses and concludes that it is but a short step from treating an exchange gain as income to treating a refund as income. It seems that decisions such as *Warner Music Australia* have managed to avoid taking this short step by shuffling sideways to find the refund assessable as income from business activities.

Applying these propositions in the lease incentive context, if there is an obligation to expend the receipt on capital expenditure that does not increase the value of the taxpayer's property and does not provide a tax deduction, then there is no assessable gain. On the assumption that a fit-out of leased premises has nominal value for the tenant and only the net cost is deducted (by way of depreciation or lease/finance payments) the decisions in *Lees & Leech, Selleck* and *Montgomery* are consistent with this principle.

9. CONCLUSION

If the lease incentive decisions herald a trend towards embracing a gain analysis of income, then there are many unresolved application issues to be

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66 See Parsons, above n 2.


68 Parsons, above n 2, para 2.125.

69 (1966) 114 CLR 537 ("Sinclair")

70 Relied upon by the High Court in Rowe.

71 (1977) 137 CLR 347.

72 A similar shuffle was performed by the High Court in Sinclair.

73 This suggests that the decision in Wattie would not be followed in Australia and Cooling would prevail.
addressed. Chief amongst these is when is there a gain and to what extent is it appropriate to trace the benefit to identify whether a gain was made?

Parsons provides some insight into these issues with the proposition that when money is received subject to an obligation to apply it to capital expenditure, then there is no gain provided the expenditure did not increase the value of the taxpayer's property. Presumably this is founded in the more general principle that only real gains are taxable.

However, it can be argued that this distinction between an obligation free receipt and one carrying with it an obligation on how it is to be expended is arbitrary and could result in both inequity and an opportunity for manipulation. Additionally, scenarios can be envisaged where the issue of whether the value of the taxpayer's property has been increased is problematical. For example, if the property has some inherent obligation attached to it and this obligation is met, is the value of that property thereby increased? Additionally, is an objective or subjective valuation process to be applied?

The fear is that this development may simply witness the substitution of one set of fine distinctions with another. On a more positive note, possibly this is symptomatic of the evolution of the judiciary along the spectrum from the flow to the gain analyses.

Fine distinctions or not, Parsons's analysis must be applauded for providing the theoretical foundation upon which to reconcile the lease incentive decisions and build consistency. The integrity of the tax system necessitates that we are witnessing the first tentative steps by the judiciary towards a paradigm shift. At a time when the rhetoric from Canberra extolls the need for an overhaul of our tax system to improve equity and simplicity, this is an opportunity for the judiciary to lead the way. Eleven years on from Myer the time for the next stride is overdue.

10. POSTSCRIPT - FC OF T V ORICA

The gain theory of income would not appear to have found much favour in the recent High Court decision in FC of T v Orica. The case concerned the assessability of the "benefit" derived from a debt defeasance transaction. Whilst the High Court held that the benefit was assessable under the capital gains tax provisions of Pt IIIA, a majority of 5 to 1 rejected the view that it was assessable as ordinary income. Although it appears to have been accepted by their Honours that a receipt need not be "incoming" to be income, a gain must be.

That is, the facts created a difficulty in that the "benefit" at issue was not the loan repayments on the taxpayer's behalf but rather the difference between these payments and the defeasing payment. Thus, it became necessary for the Court to calculate the "benefit" by comparing a single actual outlay with hypothetical outlays. In the result, the majority concluded that there was no profit, only an "accounting difference".

Whilst the facts of this decision are far removed from the lease incentive cases, the decision does illustrate a judicial caution in embracing the gain approach and the importance of having principles to assist in identifying the existence and quantum of a gain. Unfortunately, the result also gives credence to the cliche that hard cases make bad law. The decision based on the capital gains tax provisions has already been the subject of trenchant criticism and calls for legislative reform. This could have been avoided had the High Court embraced the gain approach.

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75 Under these transactions, the taxpayer makes a payment to another entity to take over its future loan repayment obligations. The excess in nominal terms of these repayments over the defeasing payment, reflecting the time value of money, is a "benefit" to the taxpayer.
76 [1998] HCA 33 (12 May), para 86.
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