THE MYER CASE AND THE TAXATION OF GAINS IN 1988

1. INTRODUCTION

The facts in the case of *F.C. of T.* v. *The Myer Emporium Ltd.* (the "*Myer Case*") raise issues as to the boundaries of the ordinary usage meaning of income.[1] The ordinary usage meaning of income is the meaning of income as developed by the Courts but which may be excluded, limited or modified by the specific provisions defining income under the Income Tax Assessment Act, 1936 ("I.T.A.A."). The Courts in developing the ordinary usage meaning of income as the basis for an income tax have borrowed the trust law meaning of income receipts which distinguishes capital receipts from income receipts. As a result of this distinction the Courts have allowed capital receipts to escape income taxation.

The decision of the High Court in the *Myer Case* is discussed in Section 2 of this paper. It may be interpreted as a surprising initiative to extend the ordinary usage meaning of income in two material ways. First the High Court held that a gain made otherwise than in the ordinary course of business which nevertheless arises from a transaction entered into by the taxpayer with the purpose of making a profit will generally speaking be income.[2] This may be interpreted as a radical extension to the ordinary usage meaning of income from business in the sense that the ordinary usage meaning of income from business now occupies much of the territory once believed to be occupied by the concept of a capital receipt. Second, the High Court held that consideration received on the assignment of the right to interest is income. This may be interpreted as extending the ordinary usage meaning of income arising as a compensation receipt by adopting a substance approach to the characterisation of a compensation receipt.[3] As a result any receipt received in respect of an assignment of what would have been income to the assignor, but for the assignment, may be income in the hands of the assignor.

Economists are long standing critics of the ordinary usage meaning of income as the basis for an income tax. Economists maintain that the essence of income is a gain to economic power rather than a receipt. In Section 3 a number of criteria are suggested in order to define more

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[1] 87 A.T.C. 4363.
[2] *Supra* n. 1 at 4365.
[3] *Supra* n. 1 at 4370.

precisely a gain to economic power. The propositions advanced in the *Myer Case* are then analysed in view of these criteria.

There has been in recent years a barrage of legislation to deal with inadequacies of the ordinary usage meaning of income. This legislation was not introduced until after the facts in the *Myer Case* arose. The recent legislation includes amendments to Division 6A of Part III of the I.T.A.A. and the introduction of Part IIIA and Division 16E of Part III into the I.T.A.A. In Section 4 of this paper the implications of each of these amendments is analysed independently of the other statutory amendments and the ordinary usage meaning of income. The analysis shows that Div. 16E of Part III of the I.T.A.A. and Part IIIA of the I.T.A.A. when considered independently of the other amendments come closer than the decision in the *Myer Case* to taxing a gain to economic power.

The I.T.A.A. contains a number of provisions designed to achieve a correlation of the statutory amendments and the ordinary usage meaning of income. These correlative provisions appear to be designed to ensure that the same receipt is not taxed twice. Unfortunately this limited aim will not always protect the taxpayer from significant over-taxation, as measured by the criteria defining the taxation of a gain to economic power, arising from the combined application of the statutory amendments and the ordinary usage meaning of income. The effect of the correlative provisions if the facts of the *Myer Case* arose again, is discussed in Section 5.

2. THE *MYER CASE*

A. *The Facts*

In 1981 Myer Emporium Ltd. ("Myer") as part of a plan to raise external finance lent $80m. for a period slightly in excess of seven years to a company called Margosa Ltd. which later became Myer Finance Ltd. ("Myer Finance"). Then, as had been originally planned, Myer assigned to Citicorp Canberra Pty. Ltd. ("Citicorp") its right to receive the interest under the loan for a lump sum of $45.37m. It was the correct characterisation of the $45.37m. in the hands of Myer that was in issue. The Commissioner of Taxation included the $45.37m. in the assessable income of Myer. Myer challenged the assessment on the ground that the $45.37m. was a capital item in its hands.

B. *The Decisions of the Courts*

Murphy, J. in the Supreme Court of Victoria found for Myer.[4] The appeal by the Commissioner to the Full Court of the Federal Court (Fox, Lockhart and Jenkinson, JJ.) was dismissed.[5] The High Court (Mason, A.C.J., Wilson, Brennan, Deane and Dawson, JJ.) in a joint judgement

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[4] *The Myer Emporium Ltd.* v. *F.C. of T.* 85 A.T.C. 4111.
[5] *F.C. of T.* v. *The Myer Emporium Ltd.* 85 A.T.C. 4601.

upheld an appeal by the Commissioner. The High Court found that the $45.37m. received as consideration for the assignment of the right to interest was income under both s. 25(1) and what is now s. 25A(1). The remainder of this Section discusses the two propositions on which the High Court decision was based and compares them to the reasoning adopted by the lower Courts.

C. *Income from Business Proposition*

The High Court advanced the proposition that a

> . . . gain made otherwise than in the ordinary course of carrying on a business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain . . . (will) generally speaking be income.[6]

This is referred to as the First Proposition.

Several difficult questions arise from this proposition. First, what does the High Court mean by the concept of otherwise than in the ordinary course of business? Second, how is a profit or gain to be identified? Third, what constitutes a purpose of profit making? These questions are discussed in the remainder of this part.

(a) Otherwise than in the Ordinary Course of Business

Both Murphy, J. in the Supreme Court of Victoria[7] and the Full Court of the Federal Court emphasised that the assignment of the right to receive interest was outside the ordinary course of Myer's business of retail. Murphy, J. cited *Van de Berghs Ltd.* v. *Clark* in which a large payment to a company in consideration for the company consenting to cancel several agreements was characterised as capital and not income from business.[8] Lord Macmillan's judgement placed emphasis upon the fact that the contracts cancelled were not ordinary commercial contracts made in the ordinary course of business.[9]

Murphy, J. and the Full Court of the Federal Court did not explicitly consider why the $45.37m. was not income from business under s. 25(1) of the I.T.A.A. However the specific references to the fact that the assignment was not made in the ordinary course of business suggests that this fact was important, if not decisive, in finding that the $45.37m. was not income under s. 25(1) of the I.T.A.A.

The High Court, in the First Proposition, expressly rejects the view that a profit or gain made in a transaction entered into otherwise than in the ordinary course of business cannot be income. As authority for this view the High Court relied upon the decisions in *Californian Copper*

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[6] *Supra* n. 1 at 4365.
[7] *Supra* n. 4 at 4116.
[8] (1935) A.C. 431.
[9] *Supra* n. 8.

Syndicate v. *Harris*[10] and *Ducker* v. *Rees Roturbo Development Syndicate*.[11] The High Court does not expressly define the scope and intended meaning of the concept otherwise than in the ordinary course of business. Rather the judgement explores the consequences of a profit being made in either the course of carrying on a business or carrying out a business operation or commercial transaction. The High Court comes to two important conclusions in regard to these consequences.

First, it recognises that if a decision to sell a capital asset is taken after its acquisition, there having been no purpose of profit-making by sale at the time of acquisition, the profit made is capital as proceeds from a mere realisation. However the High Court states it is quite another thing if the decision to sell is taken by way of implementation of a purpose of profit-making by sale existing at the time of acquisition, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.

Second, the High Court states,

> If the profit 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. And, if it appears that there is a specific profit making scheme, it is pointless to say it is unusual or extraordinary in the sense discussed.[12]

The High Court recognised that Myer's business at all relevant times was that of a retailer and property developer. As Myer acquired the right to interest with the purpose of profit-making by sale the profit made was not a mere realisation of capital proceeds. The fact that the assignment of the right to interest was novel in the sense that it was the first time Myer had entered into such an arrangement did not take it outside the course of the carrying on of Myer's profit making business.

The decision of the High Court was concerned with the case in which the taxpayer made a profit in the course of carrying on a business. However there are a number of suggestions in the judgement that a profit arising from the acquisition and sale of property with a profit-making purpose may be income regardless of whether the taxpayer is carrying on a business.

First, the High Court finds that it is because a business is carried on with a view to profit that a gain made in the ordinary course of business is income.[13] A logical consequence of this finding would seem to be that if any taxpayer makes a gain with a view to profit then, regardless of whether the taxpayer is carrying on a business, that gain is income.

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[10] (1904) 5 T.C. 159.
[11] (1928) A.C. 132.
[12] *Supra* n. 1 at 4369.
[13] *Supra* n. 1 at 4365.

Second, the High Court suggests that several strands of thought have combined so far to deter the courts from accepting the simple proposition that the existence of a purpose of profit-making is enough in itself to stamp the receipt with a character of income.[14] The first was the notion that the realisation of an asset was a matter of capital not income. However, as noted above, the High Court refused to recognise this proposition and stated that a profit will not be capital as proceeds of a realisation where the taxpayer has a profit-making purpose. The second was the apprehension that windfall gains and gains from games of chance would constitute income unless the concept of income, apart from income from personal exertion and investments, was confined to profits and gains arising from business transactions. The High Court did not discuss this strand of thought. If the simple proposition that the existence of a purpose of profit-making is enough to stamp a receipt with the character of income was accepted, then windfall gains and gains from games of chance may constitute an exception which falls outside the proposition. The third notion was that a gain generated by a recurrent transaction is income, whereas a gain generated by an isolated transaction is capital. The High Court in the *Myer Case* cites the recent High Court decision in *F.C. of T.* v. *Whitford's Beach Pty. Ltd.*[15] as clear authority for the proposition that a profit or gain made as a result of an isolated business venture does not preclude it from being characterised as income.[16] The High Court in the *Myer Case* does not however discuss the nature of an isolated business venture.

In the decision of the High Court in *F.C. of T.* v. *Whitford's Beach Pty. Ltd.*, Gibbs, C.J.[17] and Mason, J.[18] emphasize that for an operation to constitute an isolated business venture it must be an operation of business or exhibit the characteristics of a business deal even though it does not amount to the carrying on of a business. In determining whether what was done was an operation of business it is relevant to consider the purpose with which the taxpayer acted. Mason, J. suggests that apart from the consideration of purpose it may be important to show that what was involved was the operation of a business rather than the mere realisation of an asset.[19] Gibbs, C.J. considers that on the facts the extensive work of redevelopment and subdivision was more than the mere realisation of an existing asset.[20] Thus in order to establish an isolated business venture it is not sufficient to simply establish a profit-making purpose or intention on the part of the taxpayer. It is also necessary to show the transaction was an operation of business. Thus it would seem that the reasoning of the High Court in *F.C. of T.* v. *Whitford's Beach Pty. Ltd.* imposes a

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[14] *Supra* n. 1 at 4366.
[15] (1982) 150 C.L.R. 355.
[16] *Supra* n. 1 at 4366.
[17] *Supra* n. 15 *per* Gibbs, C.J. at 370.
[18] *Supra* n. 15 *per* Mason, J. at 379.
[19] *Supra* n. 15 *per* Mason, J. at 384.
[20] *Supra* n. 15 *per* Gibbs, C.J. at 370.

constraint on the acceptance of the simple proposition that a profit making purpose is sufficient to characterise a gain arising as income.

(b) The Identification of a Profit or Gain

The First Proposition advanced by the High Court required that for a receipt to constitute income there must have been a relevant profit or gain. The High Court accepted that if the two transactions, namely the loan agreement and the assignment are considered as separate and independent transactions Myer's argument that no relevant profit arose from the assignment has compelling force. This is exactly what the lower Courts did, they looked solely at the assignment. The assignment involved assigning the right to interest under the loan agreement for a consideration of $45.37m. The lower Courts could not discern any evidence of a profit arising from this transaction.

The High Court was of the view that the transactions should not be looked at independently and that by looking at the larger scheme involving both transactions a relevant profit of $45.37m. could be found. The High Court calculated the profit by first correctly stating that historical cost and not economic equivalence is the accounting basis for calculating profit under the I.T.A.A.[21]

Economic equivalence would require an application of market value principles. As a result the right to repayment of the principal of the loan and the right to interest would be brought into account, or in other words costed, at their market value at the time of acquisition. In the absence of other evidence it would appear that the market value of the right to interest at the time of acquisition was the $45.37m. Citicorp was prepared to pay for it. On this analysis the consideration of $45.37m. received on the assignment of the right to interest is not a profit. In the absence of evidence suggesting otherwise, the sum of the market values of the right to repayment of principal and the right to interest at the time of the making of the loan should equal the amount of the loan, $80m. Thus the market value at which the right to repayment of principal should be brought into account is $35.63m. The market value of the right to repayment of principal will increase over the period of the loan to equal $80m. at the time of the repayment of the loan. The increase in the market value of the right to repayment of principal in each year of income represents a profit on the basis of economic equivalence.

According to the High Court's interpretation of historical cost principles the loan would be brought into account at par and the right to interest on the money lent does not appear in the balance sheet as a separate asset at all. Thus for the purposes of the I.T.A.A. the right to interest has no cost. As a result the total amount of consideration received on the assignment of the right to interest, $45.37m., is profit.

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[21] *Supra* n. 1 at 4370 citing *McRae* v. *F.C. of T.* 69 A.T.C. 4066.

Another possible interpretation of historical cost principles is that both the loan and the right to interest should be treated as separate assets and each brought into account at cost. In the absence of a purchase price the best evidence of cost would seem to be the market value at the time of acquisition. This interpretation may be adopted by the courts if the right to interest and the right to repayment of principal are sold as separate assets with separate prices. This interpretation of historical cost principles is similar to the principles of economic equivalence in that assets are brought into account at market value. As a result, in the context of the facts of the *Myer Case*, the consideration received on the assignment of the right to interest is not a profit. This interpretation of historical cost principles is different to the principles of economic equivalence in that the right to repayment of principal is not revalued each year at market value but remains in the accounts at historical cost. The effect of this difference is that a profit only arises in relation to the right to repayment of principal when it becomes due and Myer is entitled to $80m. in repayment.

(c) The Purpose of Profit Making

The First Proposition advanced by the High Court requires that for a gain arising from a transaction to constitute income the taxpayer must have entered into the transaction with a profit-making purpose. The decision of the High Court does not seem to resolve whether a taxpayer having a number of purposes, including a profit-making purpose, satisfies the requirement of a profit-making purpose. The uncertainty arises from two aspects of the *Myer Case*.

First, it arises from the failure of the High Court in advancing the First Proposition to specify whether Myer had purposes other than a profit-making purpose in entering into the transactions. As the High Court did not reject the finding of fact by Murphy, J. in the Supreme Court of Victoria that Myer had a purpose in entering the transaction of raising working capital it would appear that it accepted that Myer had more than one purpose.[22]

Second, in advancing the First Proposition the High Court relied on *Edwards* v. *Bairstow*.[23] It is submitted, with respect, that this decision may not be authority for the decision in the *Myer Case* or the First Proposition. *Edwards* v. *Bairstow* was a case where the sole purpose of the acquisition was profitable resale and the case clearly established that if an asset is so acquired a sale to effectuate the purpose gives rise to income. However, it does not seem to be authority for the broader proposition that where only one purpose of acquisition is profitable resale, the profit arising will be income. Thus it does not appear to support the actual decision in the *Myer Case*.

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[22] *Supra* n. 4 at 4114.
[23] (1956) A.C. 14.

Although not cited by the High Court there is Canadian authority in *Norton Investments* v. *R.* that where an intention of resale is equally dominant with another purpose it is sufficient to bring profits into the category of income.[24] This case supports the decision arrived at in the *Myer Case* and would have been of benefit in further substantiating the reasoning adopted by the High Court.

The High Court cited with approval its decision in *F.C. of T.* v. *Whitfords Beach Pty. Ltd.* for the general proposition that a profit or gain made as a result of an isolated venture or a one off transaction will not preclude it from being properly characterised as income.[25] However, Hill argues the High Court failed to take into account the dicta of Mason, J. (as his Honour then was) in relation to the differences between the Australian and English Income Tax legislation.[26] According to Mason, J. the authorities have to be read with a close eye to these differences.[27] It is doubtful whether this was done in the *Myer Case* as reliance was placed upon the dicta of Lord Radcliffe in *Edwards* v. *Bairstow* which was made in the context of a provision of the United Kingdom legislation relating to an adventure in the nature of trade for which there is no equivalent in Australia.[28] Hence *Edwards* v. *Bairstow* may not be good authority in Australia for the First Proposition.

D. *Income as a Compensation Receipt Proposition*

The High Court in the *Myer Case* states that the lump sum consideration received in exchange for a right to interest is income because the taxpayer simply converts future income into present income.[29] This is referred to as the Second Proposition. As a result the $45.37m. received by Myer in exchange for the right to interest was income.

Murphy, J. in the Supreme Court of Victoria referred to Australian and English decisions which consider income as a compensation receipt. His Honour found that a receipt received in substitution for a payment will only be income as a compensation receipt to the taxpayer where the payment has been received by the taxpayer (or possibly where it falls due). Whether such a payment is received by the taxpayer depends on the nature of the agreement between the taxpayer and the assignee. Where that agreement is an agreement to assign future interest payments, as opposed to a right to future interest payments, the future payments are received by the taxpayer. As a result any receipt received in substitution for the future payments will be income. Where, however, the agreement between the taxpayer and the assignee is an agreement to assign the right to future payments the future payments will not be received by the taxpayer. As a result

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[24] 78 D.T.C. 6078.
[25] *Supra* n. 15.
[26] D. G. Hill, "A Pre-Bicentennial Reminder of our Heritage: The Myer Case" (1987) 22 *Taxation in Australia* 15.
[27] *Supra* n. 15 at 371.
[28] *Supra* n. 23.
[29] *Supra* n. 1 at 4370.

any receipt received in substitution for the future payments will not be income but capital.

Murphy, J. construed the assignment by Myer as the assignment of a right to interest.[30] Hence the $45.37m. receipt received in substitution for the right to interest was capital and not income. The reasoning of the Full Court of the Federal Court on this issue reaches the same conclusion.[31]

The High Court in advancing the Second Proposition referred to, and apparently relied upon, the decision of the United States Supreme Court in *Commissioner of Internal Revenue* v. *P. G. Lake.*[32] In that case the United States Supreme Court took a substance approach to the assignments of oil and sulpher payment rights and held that the lump sum considerations received for the assignments of the right to receive income were income on the basis that they were in substance a substitute for the right to receive income in the future. This substance approach does not recognise the distinction advanced by Murphy, J. between the assignment of a right to receive future interest and an agreement to assign future interest payments. In the context of the facts of the *Myer Case* the $45.37m. was in substance a substitute for the right to receive interest income in the future and hence income itself.

The substance approach effectively copes with the concern that stems from the potential erosion to the tax base that would arise if income receivable under a right to receive income was allowed to be turned into a non-taxable capital sum through this type of scheme. This erosion would be further exacerbated in situations like the *Myer Case* if the income received by the assignee (Citicorp) could be set against losses and the payer of interest (Myer Finance) could obtain a deduction for the interest paid. It is interesting to note that the *Myer Case* was a test case and if Myer had been successful it would have resulted in fifteen companies "minimizing" tax to the tune of $100m.[33]

In determining the scope of the substance approach the High Court drew a distinction between the case of a right to interest and right to an annuity. Consideration received on the assignment of a contractual right to receive an annuity is not income.[34] This distinction is inconsistent with the substance approach described above. Annuity payments are received by a taxpayer in respect of a right to receive income. Hence consideration received on assignment of a right to an annuity is, in substance, a substitute for a right to receive income.

There is an obvious analogy between the assignment of interest and the assignment of other income streams which are referable to a principal asset such as royalties or rent. The High Court did not however consider this analogy.

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[30] *Supra* n. 4 at 4115.
[31] *Supra* n. 5.
[32] 356 U.S. 260 (1958).
[33] Sydney Morning Herald, 7 September 1987 at 25.
[34] *Supra* n. 1 at 4370.

3. THE MYER CASE AND THE TAXATION OF GAINS

The view that income should be defined as a gain to economic power is popularly associated with the name of Henry Simons. He defined a gain to economic power over a period as

> . . . the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.[35]

A more precise definition of a gain to economic power over a period requires an elaboration of the meaning of the phrase, "the change in the value of the store of property rights". It is useful to express such a definition in terms of a number of criteria which must be satisfied. These criteria can be used to ascertain the specific reasons why the propositions advanced in the *Myer Case* fail to tax gains to economic power.

It is clear that income, defined as a gain to economic power, must include realised increases in the value of the store of property rights. This is referred to as the first criterion. The refusal of the Courts to include a capital receipt within the ordinary usage meaning of income, even where it is a realised increase in the value of the store of property rights (a realised capital receipt), is a violation of this criterion.

Both the First and Second Propositions advanced by the High Court in the *Myer Case* reduce the significance of this violation. They do so by expanding the ordinary usage meaning of income into the traditional territory of a realised capital receipt. According to the First Proposition, the consideration received on the realisation of property acquired with a profit making purpose otherwise than in the ordinary course of business, may be income within the ordinary usage meaning. According to the Second Proposition, the consideration received on the assignment of a right to income will generally be income. As noted above, to treat such consideration received on assignment of a right to interest as a capital receipt would provide an easy means of transforming assessable income into a non-taxable capital receipt. As a result of the reduction of the territory of a realised capital receipt, the volume of realised capital receipts which escape taxation can be expected to decrease. This should reduce the significance of the violation of the first criterion.

The concept of a gain to economic power as defined by Henry Simons, would seem to include all unrealised changes in the market value of the store of property rights. This is referred to as the second criterion. This criterion would, in effect, require the Courts to adopt economic equivalence as the basis for calculating income. The application of economic equivalence to the *Myer Case* was described in Section 2 above. It was found that the effect of the application of economic equivalence

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[35] H. Simons, *Personal Income Taxation*, University of Chicago Press, 1951 cited in R. W. Parsons, *Income Taxation in Australia* (Sydney, Law Book Company Ltd., 1985) at 12.

to the facts of the *Myer Case* is that the consideration of $45.37m. received on the assignment of the right to interest is not income. However, the increase in the market value of the right to repayment in a year of income is income of the taxpayer. The total increase in the market value of the right to repayment over the period of the loan would equal the consideration of $45.37m. received on the assignment of the right to interest. Thus an application of economic equivalence will not alter the total amount of taxable income of the taxpayer looking at the period of the loan as a whole. Rather, it will alter the timing of taxation and thus the discounted value of the income tax liability.

An application of historical cost principles to ascertain the change in the value of property rights, will only calculate a change in market value at the time of realisation of the property right. Generally, this will lead to a deferral of income tax liability as measured by the second criterion. However, in the *Myer Case* the High Court's interpretation of historical cost principles, as shown in Section 2 above, results in the consideration of $45.37m. received on the assignment of the right to interest being characterised as income. This interpretation of historical cost principles has the effect that income tax liability arises earlier than would be the case if the second criterion was satisfied. Since the amount of the tax liability is the same, the result of this interpretation is that the discounted value of the income tax liability is raised above the level of the discounted value of the income tax liability necessary to satisfy the second criterion. Thus this interpretation of historical cost principles, will lead to over-taxation as measured by the second criterion.

The third criterion is that a gain to economic power must not include an amount greater than the realised and unrealised change in the value of property rights. This criterion requires that if increases in the value of property rights are included in income, any decrease in the value of property rights must reduce that income. The First Proposition satisfies this criterion by expressly limiting the amount included in income to a profit or gain. The Second Proposition may, in certain circumstances, violate this criterion. These circumstances will arise where the property right, which is the source of a right to receive ordinary usage income (source property right), decreases in value in a year of income. The third criterion requires that the gain to economic power arising from the consideration received on the assignment of the right to receive payments be reduced by any decrease in value of the source property right. The Second Proposition, although it includes the consideration received on the assignment of a right to receive income is assessable income. However, a decrease in the value of the source property right will not reduce the amount of assessable income. If there is a decrease in the value of the source property right, a failure to allow or reduce the amount of assessable income leads to over-taxation, as measured by the third criterion.

This over-taxation as measured by the third criterion, is not likely to arise where the source property right is a right to repayment of principal. This is because the right to repayment of principal will not generally

decrease in value regardless of whether value is measured in terms of historical cost principles or economic equivalence. The violation of the third criterion is more likely to arise where the source property right is real property as real property is more likely to reduce in value. Real property can be the source of rent.

The fourth and final criterion is that the measure of value for the purposes of determining the change in the value of the store of property rights be the real value, as opposed to the nominal value. The ordinary usage meaning of income even when it is concerned with gains rather than receipts, such as in the First Proposition, focuses on nominal values rather than real values. In times of inflation the result of this violation is over-taxation as measured by the fourth criteria.

4. THE EFFECT OF RECENT LEGISLATION ON THE DECISION

A. *Div. 6A of Part III—Transfer of a Right to Receive Income*

The day after the handing down of the Full Court of the Federal Court decision in the *Myer Case*, the Treasurer announced substantial amendments to Div. 6A of Part III of the I.T.A.A. with effect from, and including, 10 September 1985. The amendments inserted a new s. 102CA which provides, in effect, that if a transfer of a right to receive income from property does not fall within s. 102B and consideration has been received, or is receivable in respect of the transfer, the consideration will be included in the assessable income of the transferor in the year of income in which the right is transferred. The amendments confined the operation of s. 102B to a transfer to an associate. "Associate" is defined in s. 26AAB(14) of the I.T.A.A., to include a company accustomed or under an obligation to act in accordance with the directions, instructions or wishes of the taxpayer company. There is no evidence Citicorp was under such an obligation or so accustomed. It follows that if the facts in the *Myer Case* arose again the consideration of $45.37m. received in respect of the transfer of the right to interest would be assessable under s. 102CA in the year of income in which the right was transferred.

Section 102CA gives legislative effect to the Second Proposition advanced by the High Court in the *Myer Case* which is described in Section 2 above. Thus an assessment of s. 102CA in terms of the criteria defining a gain to economic power, discussed in Section 3 above, will reach the same conclusions as were reached in relation to the Second Proposition.

B. *Part IIIA—Capital Gains Provisions*

Part IIIA was introduced into the I.T.A.A. by the Income Tax Assessment Amendment (Capital Gains) Act, 1986. Part IIIA includes in the assessable income of the taxpayer, a net capital gain which accrues to the taxpayer in respect of a year of income on or after 20 September 1985: ss. 160ZO(1),160L. The amount of a net capital gain will depend on the amount of capital gain: s. 160ZC. A capital gain arises where the

consideration in respect of the disposal of an asset acquired on or after 20 September 1985 exceeds the indexed cost base to the taxpayer: ss. 160Z(1),160L. The amount of the capital gain equals the amount of excess: s. 160Z(1). The facts in the *Myer Case*, if they arose again, would create some difficult problems in characterisation for the purposes of Part IIIA. This section explores these difficulties.

Parsons submits that a disposal of a right to future interest under a debenture is a part disposal of an asset for the purposes of Part IIIA.[36] He argues, as a result of this characterisation, that there must, under s. 160ZI, be an apportionment of the cost base of the debenture between the rights to future interest and the right to repayment of the principal sum. S. 160ZI(1) provides that where part of an asset is disposed, the cost base of the asset shall be apportioned rateably, between the disposed part and the undisposed part, according to the values of the disposed part and undisposed part. The cost base of an asset is defined in s. 160ZH(1) and includes the amount of consideration in respect of the acquisition. For the purposes of the apportionment, the value of the disposed part is the consideration in respect of the disposal and the value of the undisposed part is market value: s. 160ZI(1).

The facts in the *Myer Case* involve a disposal of a right to future interest under a debenture. The loan agreement is a debenture. If Parsons' characterisation and argument is correct, then, if the facts in the *Myer Case* arose again, it would be necessary on the disposal of the right to interest to apportion the cost base of the loan agreement rateably according to value between the disposed part and the undisposed part. The cost base of the loan agreement is the amount of consideration paid in respect of the acquisition of the loan agreement which is $80m. The value of the right to interest is the consideration paid in respect of the disposal of the right to interest which is $45.37m. In the absence of other evidence it would appear, as suggested above in Section 2, that the market value of the right to repayment of principal is the difference between the amount of consideration paid on the acquisition of the loan and the market value of the right to interest at the time the loan was made. It is assumed in the absence of other evidence that the market value of the right to interest at that time was $45.37m. Hence the value of the right to repayment of principal at the time of the acquisition of the loan is $34.63m.

Given these values it is possible to apportion the cost base of the loan agreement, equal to $80m., rateably according to value between the disposed part and the undisposed part. The result is that $45.37m. will be apportioned to the right to interest and $34.63m. will be apportioned to the right to repayment of principal.

In order to calculate whether a capital gain arises in relation to the assignment of the right to interest it is necessary to determine if the assignment constitutes a disposal. S. 160R provides that a reference to

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[36] R. W. Parsons, A Survey of the General Provisions of Part IIIA, mimeo, University of Sydney Law School, 1986.

the disposal of an asset includes a reference to the disposal of part of an asset for the purposes of Part IIIA. The assignment of the right to interest is clearly a change in the ownership of an asset such as to constitute a disposal of an asset as defined in s. 160M(1). It is then necessary to ascertain the consideration received on disposal of the right to interest and the cost base: s. 160Z(1). Following Parsons' characterisation the apportioned cost base of the right to interest, equal to $45.37m., is in fact equal to the consideration received on the disposal of the right to interest. As a result there can be no capital gain in respect of the disposal of the right to interest: s. 160ZJ, s. 160Z(3), s. 160Z(1).

There is however likely to be a capital gain on the repayment of the principal. S. 160M(3) defines a disposal of an asset to include the satisfaction of a debt. Clearly the right to repayment is an asset in the nature of a debt and the repayment of principal is the satisfaction of the debt. Thus the repayment of principal is a disposal of an asset. The consideration received in respect of the disposal of the right to repayment is $80m. This will most likely significantly exceed the indexed cost base of the right to repayment where the attributable cost base is $34.63m. and the term of the loan is 7.25 years. The amount of the excess will be a capital gain.

The effect of Part IIIA as interpreted by Parsons, in the context of the facts in the *Myer Case*, is to displace the interpretation of historical cost principles advanced by the High Court in the *Myer Case*. Part IIIA in calculating the amount of the consideration received on the disposal of a right to interest which is taxable as a capital gain, determines the cost base of the right to interest by market value principles: s. 160ZI(1). The High Court interprets historical cost principles as requiring that the cost of the right to interest be zero for the purposes of calculating the amount of the income derived in respect of the assignment.

The effect of Part IIIA in the context of the facts of the *Myer Case*, as interpreted by Parsons, is to impose tax liability at the time of the disposal of the right to repayment of principal rather than at the time of an unrealised increase in the value of the right to repayment. Thus s. 160ZI(1) as interpreted by Parsons, violates the second criterion defining a gain to economic power discussed in Section 3 above. This violation, because it in effect defers income tax liability as measured by the second criterion, will result in under-taxation as measured by the second criterion.

The effect of s. 160ZJ of the I.T.A.A. is that Part IIIA will only include a net capital gain which, in terms of the fourth criterion defining a gain to economic power discussed in Section 3 above, represents an increase in the real value, rather than the nominal value, of an asset disposed by the taxpayer. This is achieved through the mechanism of an indexed cost base. In the context of the facts of the *Myer Case*, the effect of s. 160ZJ is that Part IIIA as interpreted by Parsons, will only include a net capital gain which represents an increase in the real value of the right to repayment of principal. Thus s. 160ZJ satisfies the fourth criterion defining a gain to economic power discussed in Section 3 above.

It is possible that the Courts will take the view that s. 160ZI does

not displace the principle that historical cost accounting is the accounting basis for the calculation of profit under the I.T.A.A. This view may be supported by s. 160ZI(2). Parsons, in his argument, did not consider s. 160ZI(2). This section provides that s. 160ZI(1) shall not be taken as requiring an apportionment of an amount that, on the facts, is wholly attributable to the undisposed part of the asset. The scope of s. 160ZI(2) is not certain. It would seem that s. 160ZI(2) would certainly apply where there were separate purchase prices for the undisposed part of the asset and the disposed part of the asset and the two parts are merged into a single asset. In such a case the cost base of each part is the purchase price of the part. Whether it would apply where there are no separate purchase prices is uncertain.

It is arguable that the cost of the loan in the *Myer Case* is, on the facts of accounting practice, wholly attributable to the right to repayment of principal so that s. 160ZI(1) does not apply. If this is the case then the cost base of the right to repayment of principal is $80m. and there will be no capital gain on the disposal of the right to repayment of principal. If the cost base is wholly attributable to the right to repayment of principal then the cost base of the right to interest is zero. There will be a capital gain arising on the disposal of the right to interest of $45.37m.

Alternatively, it may be argued that Myer in assigning the right to interest was disposing of an asset that did not exist (either by itself or as part of another asset) before the disposal but was created by the disposal. This characterisation is supported by Fox, J. in the Full Court of the Federal Court decision in the *Myer Case*: "What was 'acquired' was the future periodical produce of a loan, and it was created rather than 'acquired' ".[37] If this is the correct characterisation then it would follow that s. 160M(6) would deem the disposal a disposal of an asset for the purposes of Part IIIA. By virtue of s. 160M(5)(c) and s. 160M(6) the whole $45.37m. paid on disposal of the interest will constitute a gain under s. 160Z(1).

The end result of this particular characterisation is identical to the characterisation of the disposal of the right to interest as a part disposal where s. 160ZI(2) is applied as described above. However, this particular characterisation suffers from the weakness that the High Court in the *Myer Case* expressly stated that a right to interest is an existing chose in action unless, perhaps, a borrower can avoid liability for interest by repaying the loan. If this principle applies to the characterisation of the disposal of the right to interest under s. 160M it follows that on the facts in the *Myer Case* the right to interest was an existing chose in action. Thus s. 160M(6) would not apply.

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[37] *Supra* n. 5 at 4605.

C. *Div. 16E of Part III—Accruals Assessability in Respect of Certain Security Payments*

If Parsons' characterisation of a disposal of a right to interest in the context of Part IIIA is accepted, Div. 16E of Part III may further affect the position of the taxpayer. Div. 16E of Part III was introduced by Act No. 49 of 1986 to alter the basis for taxing amounts accruing on certain discounted and stripped securities from a realisation basis to an accruals basis.

Section 159GQ provides, in effect, that where a taxpayer is the holder of a fixed return security during an assessability period there shall be included in the assessable income of the taxpayer in a year of income an amount equal to the sum of the notional accrual amount. The notional accrual amount is calculated in terms of a yield to redemption: s. 159GP(1). The yield to redemption is essentially the compound interest rate per period at which the sum of the present values of all amounts payable under the security during the term of the security equals the issue price of the security: s. 159GP(1). The issue price of the security is the amount paid in consideration for the security: s. 159GP(1).

Where the yield to redemption is equal to the market rate of interest then the notional accrual amount in relation to a security will equal the unrealised increase in the market value of that security. Thus in the special case where the yield to redemption is equal to the market rate of interest s. 159GQ will satisfy the second criterion defining a gain to economic power discussed in Section 3 above. The yield to redemption is only likely to equal the market rate of interest if the market rate of interest does not change. Since the market rate of interest is likely to change the yield to redemption s. 159GQ can be considered as an approximate measure of the increase in the unrealised market value of the security which avoids the difficulty of ascertaining the change in the market rate of interest. Thus s. 159GQ, if applicable, is an approximate means of satisfying the second criterion defining a gain to economic power discussed in Section 3 above.

The notional accrual amount is calculated in terms of nominal values rather than real values. Thus s. 159GQ, if applicable, violates the fourth criterion defining a gain to economic power discussed in Section 3 above. In times of inflation this violation will lead to over-taxation as measured by the fourth criterion.

Section 159GZ extends s. 159GQ to stripped, or in the wording of s. 159GZ, separate securities. Essentially s. 159GR deems a taxpayer to be the holder of a separate security where the taxpayer acquires a security (referred to as the underlying security) and the taxpayer transfers one of the rights to another person. Thus, on the facts of the *Myer Case* if they arose again, the taxpayer after transferring the right to interest but not the right to repayment of principal to another person will be the holder of a separate security. The separate security is the right to repayment of principal.

Where the issue price of the underlying security is equal to the market value of the underlying security at the time of the issue of the underlying security, the issue price of the separate security is deemed to be its market value at the time of the issue of the underlying security. On the facts of the *Myer Case* there is no evidence suggesting that the $80m. paid in consideration for the underlying security, the loan agreement, is not the market value of the loan agreement. Hence the issue price of the separate security, the right to repayment, will be its market value at the time of the issue of the loan agreement. The market value of the right to repayment of principal at the time of the issue of the loan agreement was calculated above to equal $34.63m.[38]

The effect of s. 159GQ, if applicable to a separate security, is to include an amount in income equal to the notional accrual amount which is calculated on the basis of a yield to redemption. In the context of the facts of the *Myer Case* the effect of s. 159GQ, if applicable, is to include the difference between the issue price of the right to repayment, $34.63m., and the sum of all payments due under the right to repayment, $80m., in assessable income over the term of the loan. In each assessability period an amount will be included in assessable income calculated according to the yield to redemption.

S. 159GQ is subject to s. 159GX which provides in effect that the whole or part of a payment in respect of a security will not be assessable under s. 159GQ unless the payment or a part of the payment when actually made or liable to be made would be included in assessable income under some other provision of the I.T.A.A. If, in the context of the facts of the *Myer Case*, part of a payment in respect of the right to repayment of principal when actually made is assessable under a provision other than s. 159GQ that part of a payment will not be assessable under s. 159GQ.

If Parsons is correct and s. 160ZI(1) of Part IIIA would apply to the facts in the *Myer Case* if they arose again, a capital gain would arise on the disposal of the right to repayment of principal equal to the amount of the repayment less the indexed cost base. It is, however, a net capital gain rather than a capital gain which is included in assessable income under s. 160ZO. Thus it is not possible to say in any formal sense, that the repayment of the principal would be included in assessable income under some other provision of the I.T.A.A. other than s. 159GQ. It follows that s. 159GQ would not apply to the right to repayment of principal.

At first glance this argument may seem excessively formalistic. It may be argued that part of the repayment will, in substance, be included in assessable income under Part IIIA. Whether this substance approach will be adopted is uncertain. The problem with this substance approach is that if a taxpayer incurs capital losses on other assets in the year of repayment there may be no net capital gain and it will be difficult to identify any part of the repayment in assessable income. If this substance approach is rejected, then s. 159GQ would not apply.

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[38] *Supra*, Section 2, Part B.

5. CORRELATION OF THE RECENT LEGISLATION

The I.T.A.A. contains a number of provisions designed to achieve a correlation of the statutory amendments outlined in Section 4 above and the ordinary usage meaning of income. These correlative provisions appear to be designed to ensure that the same receipt is not taxed twice. Unfortunately this limited aim will not always protect the taxpayer from significant over-taxation, as measured by the criteria defining the taxation of a gain to economic power, arising from the combined application of the statutory amendments and the ordinary usage meaning of income. The effect of the correlative provisions on the facts of the *Myer Case* is discussed in this Section.

Section 160ZA(4) of Part IIIA of the I.T.A.A. provides that where as a result of the disposal of any asset an amount, or amounts, has or have been, or will be included in assessable income of any year of income under a provision of the I.T.A.A. other than Part IIIA, any capital gain in respect of that disposal will be reduced by that amount.

If Parsons is correct and s. 160ZI(1) would apply to the facts of the *Myer Case* then a capital gain will arise on the disposal of the right to repayment of principal. Section 102CA and the *Myer Case* will not include in assessable income an amount in respect of the disposal of the right to repayment of principal. Rather they will include an amount in respect of the disposal of the right to interest. The fact that the taxpayer will be assessed on an amount in respect of the disposal of the right to interest will not protect the taxpayer from being assessed on a capital gain arising on the disposal of the right to repayment.

It was shown in Section 3 above, that the decision in the *Myer Case* leads to violation of all four criteria defining a gain to economic power. Each violation will lead to over-taxation as measured by the criteria. Hence the inclusion of part of the repayment of principal in income under Part IIIA will increase the amount of over-taxation as measured by the criteria. It is also expected that such an inclusion will discriminate against the particular type of transaction entered into by Myer in favour of other transactions which do not lead to the same degree of over-taxation as measured by the criteria.

It was suggested in Part D of Section 4 above that it is possible, although unlikely, that s. 159GQ will apply to the facts of the *Myer Case*, if they arose again. The effect of s. 159GQ, if applicable, would be to include in assessable income an amount equal to the notional accrual amount in respect of the right to repayment of principal. In effect the notional accrual amount is calculated to include some part of the difference between the sum of payments payable under the right to repayment of principal and the issue price of the right to repayment of principal.

The only payment payable under the right to repayment of principal on the facts of the *Myer Case* is the repayment. The repayment arises on the disposal of the right to repayment of principal. Hence it is as a result of the disposal of the right to repayment of principal that an amount will have been included in assessable income under s. 159GQ at the time of

the disposal of the right to repayment of principal. Thus s. 160ZA(4) will have the effect that any capital gain arising on the disposal of the right to repayment of principal will be reduced by the amount included in respect of that disposal under s. 159GQ. Thus the application of s. 159GQ to the facts of the *Myer Case* will not reduce, and may increase, the over-taxation as measured by the criteria defining a gain to economic power.

It was suggested above in Part B of Section 4 that s. 160ZI(1) may not apply to the facts of the *Myer Case* but instead s. 160ZI(2) or s. 160M(6) of the I.T.A.A. may be applicable. If either s. 160ZI(2) or s. 160M(6) is applicable then a capital gain will arise on the disposal of the right to interest but no capital gain will arise on the disposal of the right to repayment of principal. An amount will be included in assessable income in respect of the disposal of the right to interest under s. 102CA. Hence the capital gain arising on the disposal of the right to interest will be reduced by this amount under s. 160ZA(4). As a result of this reduction an application of s. 160ZI(2) or s. 160M(6) to the facts in the *Myer Case* will not lead to some degree of over-taxation, compared to an application of s. 160ZI(1), measured by the criteria defining the taxation of gains to economic power.

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