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Defining Ordinary Income after *McNeil*

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Abstract
The High Court decision in *FCT v McNeil* (2007 HCA 5) decided that the market value of put options issued to shareholders over their shares in the company, as a mechanism for carrying out a share buy-back, was ordinary income at the time of issue in the hands of those shareholders who chose not to participate. The jurisprudential basis on which this decision was made is not manifestly clear, but the impact of the decision has the potential to set aside the traditional distinction which has been made between receipts which are on revenue account and those which are on capital account. This article seeks to establish that the approach which is manifest in *McNeil* is out of step with established principles and that the High Court provided no convincing reasons for setting aside the principles which have traditionally been accepted as determining which receipts are to be regarded as being on revenue account. This article seeks to show that the approach which is manifest in *McNeil* was also apparent in the earlier majority High Court decision in *FCT v Montgomery* (1998) 198 CLR 639, although *McNeil* does not appear to have relied on *Montgomery*. However, the authors seek to establish that the principles which can be derived from the majority decision in *Montgomery* are not sustainable. The problem which emanates from *Montgomery* is identified and a return to the position which existed prior to *Montgomery* is advocated as the solution to the problem which now exists. It is suggested that the legislative response of creating different tax treatment for call and put options is a disappointing response, with a preferable approach being the restoration of the previous tax treatment, which had been the undertaking given to industry and capital markets by the government.

1. INTRODUCTION

It might have been anticipated that by the beginning of the 21st century the principles used to determine what constitutes income according to ordinary concepts for the purposes of the *Income Tax Assessment Acts* 1936 and 1997 (Cwlth), would be clear and settled. Regrettably, that is not so.[1] The confusion which has arisen is largely attributable to recent law making by the High Court. *Federal Commissioner of Taxation* (“*FCT*”) *v Montgomery,*[2] decided in 1999, is an early manifestation of the High Court’s attempt to set aside established principles.

The impact of the High Court's decision was not properly appreciated until the Australian Taxation Office ("ATO") subsequently issued a draft class ruling to Hutchison Telecommunications[4]

ordinary income. Furthermore, it is argued that no convincing reasons were apparent for setting aside time-honoured principles, and that there is arguably an internal tension in the reasoning of the majority decision in characterising the nature of the put option.

While there has been commentary on the practicalities and potential impact of the decision in *McNeil*,[8] this analysis seeks to identify and examine in greater detail the jurisprudential underpinnings of the judicial reasoning underlying the majority High Court decision, and demonstrate how this reasoning accords with, or diverges from, established principles and decided authority that existed prior to the *McNeil* decision.

This examination is carried out by referen

shareholder was entitled was proportional to the member's shareholding. The sell-back rights were issued without consideration. The sell-back rights were not granted to the shareholders directly. Instead, they were granted in favour of a trustee company, which undertook to hold the number of rights to which shareholders were entitled on separate trusts for the absolute benefit of each shareholder.

If a shareholder wished to sell into the share buy-back, the shareholder was required to give notice to the trustee to vest the sell-back rights in the shareholder, so that the shareholder could then exercise the put option and require SGL to buy back the requisite number of SGL shares. SGL had assumed an obligation to do so under the interconnected documentation.

If a shareholder did not wish to sell shares, then the shareholder was not required to do anything. But in this situation the trustee company was obliged to take steps to require a merchant bank to sell those sell-back rights and account to the shareholder for the proceeds of sale (if any). The merchant bank was under a similar duty to account for the proceeds of sale, although this obligation could be satisfied by transferring the money to SGL, which would then account to the shareholder.

The taxpayer was one of those shareholders who took no steps to exercise the sell-back rights. As a result, the trustee required the merchant bank to sell her rights. The merchant bank did so. The trustee then accounted to the taxpayer for her proportional share of the net proceeds of sale arising

be based on perceptions which were later found to be incorrect, or dependent on tax consequences which were not then known.

The two limbs of the majority decision appear to be that:

1) a determination about whether a receipt has the character of the derivation of income depends upon its quality in the hands of the recipient, not the character of the expenditure by the other party.
2) a determination about whether the gain arising from shares has an income characterisation depends on whether the gain has been severed from the shares.[9]

While these two limbs will be considered separately, they inevitably converge.

4. IMPACT OF *MCNEIL*'S CASE

Rights issues have been a popular capital raising method in Australia. For the period 2002-06 it has been estimated that some $26 billion had been raised in this way.[10] The ruling was seen as jeopardising this market both at the institutional and individual level, because of adverse tax consequences. As a response to the criticism which erupted, the Minister for Revenue announced that the pre *McNeil* position for taxing rights issues would be restored, with effect from the 2001–02 income year – as a tax compliance initiative.[11] The long standing position of treating rights issues as being on capital account would be maintained and chan

long as the income has been derived by the taxpayer. Then s6-5(4) goes on to provide an extension to the concept of derivation, in that a taxpayer is taken to have received income according to ordinary concepts as soon as it is applied or dealt with on the taxpayer's behalf, or as the taxpayer directs.

So first of all, the ITAA 1997 requires a receipt to be identified as income and then once identified, a determination needs to be made about whether it has been derived by the relevant taxpayer. There are two steps in this process, not one. Income cannot be derived until a receipt of an income nature has been identified. The ITAA 1997 does not define income, other than to provide that it includes income according to ordinary concepts. Nor does the ITAA 1997 define the concept of income according to ordinary concepts, or the concept of derivation.

The leading statement of principle regarding the nature of income is to be found in the judgment of Jordan CJ in *Scott v Commissioner of* Taxation[14]:

The word income is not a term of art, and what forms of receipt are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind...."[15]

In considering the meaning of income according to the "*ordinary concepts and usages of mankind,*" the courts have not adopted the economist's broad view that income is an accretion to economic or spending power. This was the view advocated by the leading American economist Henry Simons in the late 1930's in his text *Personal Income Taxation*[16]. It was also reflected in what Lord Kaldor said in his dissent to the United Kingdom *Royal Commission's Final Report on the Taxation of Profits and Income, 1955.*[17]

There have been more recent attempts to popularise economic concepts of income. In 1998 the *Review of Business Taxation* considered that economic income would provide a better base for taxing, as the same economic transaction should not be subject to different taxation treatment because of differences in form. But this view has not been embraced by the courts, although there have been some recent moves in this direction taken by Parliament.[18]

In considering what may be regarded as income according to the "*ordinary concepts and usages of mankind,"* Professor R Parsons, in his definitive text, *Income Taxation in Australia*

must be something which comes in[21]. This latter component relates to the concept of derivation. However, there cannot be a derivation until a gain with an income character has been identified.

In his text Parsons turns to make a number of assertions, or propositions, which can be used in a general way to identify receipts as income. It is proposed to benchmark the principles which emerge from *McNeil's* case against these propositions, but since *McNeil's* case concerned the characterisation

decision of the Supreme Court of the United States of America in *Eisner v Macomber.*[27] There it was said that

The fundamental relation of 'capital" to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop: the former being depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time….
…Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived', that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal: – that is income derived from property.[28]

From this passage it can be seen that the essence of the nature of a gain arising from the use of property is that there must be a severance of the gain from the property, before it can be said that any income arises. This passage was accepted in Australia by the High Court in *Mont**.3(va)7.4(co(cm(45738 0e[((th43.6(ser)5738 0e01033( )t8 Tc0.06s)4.7i)-5.7(s)2dc1r*

payer was not relevant. That statement does not accurately reflect the second of Parsons propositions referred to above. Nowhere in his text did Parsons state that the character of the amount in the hands of the payer was irrelevant. But it followed, in the view of the majority in *McNeil*, that the character of the sell-back right could be determined by isolating the receipt from the SGL buy-back process, which arose out of the capital restructuring of SGL.[39] This was despite determinations to the contrary in the Full Federal Court, when *McNeil* was before that court.

GP International Pipecoaters Pty Ltd v FCT,[40]

established the test as being "*whether a receipt comes in as income must always depend for its answer upon a consideration of the whole of the circumstances.*"[45]

That approach was endorsed in 1987 by *FCT v The Myer Emporium Ltd*,[46] a unanimous decision of the High Court. This case involved the characterisation of the receipt of a payment made for an assignment of interest payable under a loan. Myer Emporium had lent funds to its finance subsidiary and immediately assigned the income stream arising under the loan to an independent finance company for a lump sum. Myer Emporium argued that the payment made to it under the assignment was an extra-ordinary receipt for a retailer and property developer and as such was on capital account, thereby escaping the normal rule that a receipt by a business in the normal course of its business was on revenue account.

The Court disagreed and held that the receipt was on revenue account. The Court accepted that if the assignment could have been regarded as a separate transaction, it may have been possible to say that no gain of a revenue nature would have arisen, because the receipt of the value of the chose-in-action assigned could have been seen as the realisation of a capital asset. But when the facts were viewed as a whole, particularly the fact that the taxpayer had assigned its interest under the loan immediately after the loan was advanced, in order to obtain the immediate benefit of the future interest payments, the receipt was seen as a receipt on revenue account, because it represented no more – nor less – than the quantified present value of the future interest payable under the loan. As a consequence the receipt was not a capital item.

Pipecoaters, which was decided after Myer Emporiu

necessarily the same as the factors relevant to the ascertainment of the character of its payment.[47]

The emphasis, which is apparent here, on the whole of the factual matrix, is underscored by the reference made later to the need to apply "*a business conception to the facts, see FCT v Becker (1952) 87 CLR 456 at 467*"[48] when characterising a receipt.

In making these observations on the characterisation of receipts, the High Court in *Pipecoaters* did not say that the nature of the payment in the hands of the payer was irrelevant: simply that its nature in the hands of the payer did not determine its character in the hands of the recipient. Nor did *Pipecoaters* say that the general context in which the payment was received was irrelevant, or that only part of the facts should be considered. On the contrary, it said that characterisation was determined by considering the whole of the factual matrix. These observations accord with Parsons' view on this issue.

Myer Emporium is also important for two other things which it established in relation to the characterisation of receipts.

First, it accepted longstanding authority that a gain derived in the course of carrying on a business is income. Where the transaction which gives rise to the profit is part of the ordinary business of the taxpayer, the identification of the business itself may characterise the receipt. For instance, the profit on the sale of shares by a share-trader would be on revenue account. The same situation would arise where the sale is part and parcel of the business activity of the taxpayer, even if it is not the main business, because the profit-making purpose can be inferred from the association of the transaction with that business activity. So, if a taxpayer dealt in shares and switched investments regularly to maintain a growth pr ia3(t)-7.e f0 39.te6o4.6(tty)-16(. .7(o8.4(n)4.7(e)as a)-Il)

security, or is it a gain in an operation of business in carrying out a scheme for profit-making."

In applying what was said there, it is necessary to undertake a *"wide survey and an exact scrutiny of the taxpayer's activities.*"[58] So in this regard the approach accords with that developed in *Pipecoaters* and *Myer Emporium*. The approach is manifest in such cases as *Hayes v FCT*,[59] which involved the characterisation of the receipt of a gift.

This was how things stood until *Montgomery* reached the High Court in 1999.In this case the Court was required to characterise a payment received by a firm of lawyers as an inducement to take a lease of commercial premises. In the Full Federal Court it had been found that the inducement was an extra-ordinary payment, when gauged against the firm's normal activities, and one which the firm had received not for the purpose of obtaining the inducement, but for the purpose of obtaining new premises from which to carry on business. As such, the receipt was on capital account. In reaching this conclusion the Full Federal Court applied accepted principles and its approach was entirely in line with *Myer Emporium.*

In the High Court, by a majority, that conclusion was reversed. The receipt was found to be income. To reach this conclusion on

adopted as the precedent. It was not used in this context at all. The judgment gives the impression the majority was merely expounding an orthodoxy.

5.2.2 General principles – Severence of gain from shares

The second general principle upon which the majority in *McNeil* relied was that a gain from property has the character of income, if it has been severed from the underlying property.

This was also an issue in *Montgomery*. The majority in that case concluded that the inducement payment was not a gain which was linked to the lease and therefore capital, but a gain severed from the lease. Reference was made to what was said in *Eisner* that there was "*not a gain accruing to capital….but a gain…severed from the capital however invested or employed, and coming in, being derived, that is received or drawn by the recipient (the taxpayer) for his separate benefit and disposal*."[62] In explaining the application of this principle to the facts, the majority said that the taxpayer had exploited its capital in securing the inducement and it was received, not as some growth or increment in value to its profit-yielding structure, but as a payment severed from that and available to the taxpayer for use as it saw fit.

The minority rejected the view that the payment could be seen as fruit arising from the firm's capital. The principal reason was that at the time of the payment the lease itself was not property of the firm. Nor could it be regarded as being the fruit arising from the exploitation of the firm's goodwill or reputation, since the payment was not severed from its reputation. The minority considered that there was an inexorable link between the incentive payment and the assumption of the obligations of the lease in the same way that such payments were regarded in England and New Zealand. For these reasons the incentive payment was not the fruit of the firm's capital.[63]

It is at this point that it can be seen that the two elements of the characterisation inquiry intersect: the necessity to determine that a gain must be severed from capital before it can be regarded as income, and, the factual matrix against which the gain, in the hands of the recipient, is considered. It is clear that the majority in *Montgomery* was able to regard the inducement payment as having been severed from the lease only because it chose to regard the payment as being divorced from the background facts which gave rise to it. As such it was devoid of any character. But having been received in the course of the taxpayer's business, it could therefore be regarded as having an income character.

The problem which this creates is manifest. If the character of a receipt can be determined in this way, then the receipt will always be capable of being seen as a receipt coming in as part of the recipient's income revenue. But as already indicated, the Full Federal Court in *Spedley* said, that to view the matter so broadly would be contrary not only to authority, but also to the provisions of ITAA and basic concepts

since by its own analysis, the rights had been shown to be separate capital assets created independently of the underlying shares.

This incompatability between the two strands of reasoning creates a tension in the judgment which is difficult to reconcile.

If their Honours were suggesting that the rights were 'shorn from the shares' then this would suggest, using the Eisner analogy, that the rights represented a return on the shares rather than a return of some part of the rights attached to the shares, and such a return could then be seen as analogous to a dividend return, and take an income character.

The tension in the reasoning is highlighted by the second strand in the judgment which suggests that the rights were items of distinct property, being solely a creation of the deeds poll as "The scheme took its life from the deeds poll executed on the record date".[73] On this basis the rights had no relationship at all with the shares themselves, and could not be seen as representing a return on the shares, or a return of some part of Mrs McNeil's rights as a shareholder.

It is suggested that in this latter conception of the rights being property distinct from the shares, the High Court has failed to view the entire factual matrix, as a review of the complete facts would reveal the rights as a mechanism for a return of capital by means of a share buy-back. So much would appear to be suggested by Callinan J when noting that "The fact that the capital of the company suffered a reduction is far from irrelevant".[74]

Given this apparent tension in the *McNeil* judgment, the discussion that follows analyses previous authorities which have examined the issue of the nature of the rights carried by shares. It is suggested that reference to previous authorities on this issue casts the *McNeil* decision as an example of a judgment which is difficult to support on the basis of the previously existing authorities.

7. CHARACTER OF *MCNEIL* SELL-BACK RIGHTS

The sell-back right was a put option. Since SGL wished to achieve a reduction in its share capital of a pre-determined percentage and it was anticipated that there would be a market in these rights, the put option mechanism was a vehicle for effectuating that commercial objective. It was anticipated

attached to the share, and, can then be seen as having been shorn from the share to which it relates.

Traditionally, a share has been described as a chose-in-action, but this is not particularly helpful as this description is notoriously vague. The authorities show that a share is a bundle of rights and those rights are the ingredients of the chose-in-action. The one right it does not confer is a right to a physical thing. The classic statement regarding the nature of a share is to be found in what Farwell J said in *Borland's Trustee v Steel Bros & Co Ltd:*

A share is the interest of a shareholder measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with (the appropriate companies legislation). The contract contained in the articles of association is one of the original incidents of the share. A share…is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.[75]

The reference here to measuring the interest by a sum of money was a reference to the par value of a share. That is no longer quite as apposite, since *the Company Law Review T.9(o)-c8adn6 16aob5.8[(R)-5303 429derpar .9( )(2)nssharRe1iTlny Lmp5.86ar5.8[(R)-5303 421erR*

the provisions of the company's constitution. That right, together with all the rights which a shareholder has, was seen as arising out of the "

company's constitution and the relevant companies' legislation. A right or option to take up shares is not an inherent part of a share. It arises independently – out of the contractual arrangements which exist between the company and its shareholders – from the actions of the company.

Whether a shareholder has any entitlement depends on the actions of the company. This can be tested by reference to an example. A right to a new issue of shares need not necessarily be made to existing shareholders. If a right to a new issue of shares were granted to a company's financiers, who were not shareholders, it would be difficult to argue that the entitlement to take up the new issue arose out of the shares in the company already on issue. Once created, the entitlement is a separate item of property, but it is not an item of property which is shorn from the share itself. If options to take up new shares are property separate from the shares themselves, then a fortiori, options created over shares, in order to create a mechanism to sell them, would also be separate from the shares themselves.

8. IMPORTANCE OF CAPITAL REDUCTION TO SELL-BACK RIGHTS

Share buy-backs are reductions of capital. One of the main cases to examine the nature of a share specifically in relation to a reduction of capital was *Archibald Howie*. Here, Dixon J made the point that when a shareholder contributes the amount paid for the share to the capital of the company, this contribution measures his right to any return of capital which the company may make, either as a going concern, or on liquidation. Today this would probably be rephrased to indicate that his shareholding affords him a proportional right to share with other shareholders in a distribution of the capital of the company. But what the case makes clear is that this right is conferred by the contract of membership, which arises from the company's constitution.

As Dixon J said "*The reduction involving the payment off of part of the paid up share capital must therefore be considered an effectuation of a provision of the contract of membership.*"[85] Thus the right to a return of capital arises out of the contract which exists between the company and the shareholder. It must follow that the right to participate in a reduction of capital is not imbedded in the share itself: it arises from the contractual arrangement which exists between the company and the shareholder.

Archibald Howie and *Uther* both make it clear that a return of capital does not constitute a severance of a capital amount, or indeed anything else, from the share itself. It represents a receipt by the shareholder of a part of the underlying asset value of the share. Once it has been received, the underlying value of the share has been irretrievably diminished and so has the right to receive further returns of capital. Indeed, if the capital has all been repaid, then the right has been entirely satisfied. But, it is not accurate to describe that impact as the severance of a gain. What has happened is that the shareholder has given up part (or all) of the entitlement to the profit yielding structure. This is entirely consistent with

In *McNeil* the majority did not refer to *Archibald Howie,* but did refer to *Uther*, and certain other liquidation cases.[86] However, these authorities were rejected on the basis that they afforded no sound analogy. *Miranda* and *Macmine* were also rejected, on the grounds that they were not cases concerned with the revenue nature of the rights

found that this would be the case, even if the rights offered to existing shareholders contained an element of bonus to the shareholders. But even more importantly the judge suggested that a resolution to return capital created a legal right in the shareholders and that this legal right was a right which flowed from the original issue of shares and was passed on by the registration of shareholdings. It would follow that if the legal right arose from the shareholding, it could not have emanated solely from the resolution to return capital.

On this basis, it becomes difficult to reconcile the High Court's view that the sell-back rights did not represent part of the rights carried by a share, but were created solely by the covenant. It may appear that the High Court's view accepts part of the reasoning of Gibbs J in *Archibald Howie* that the resolution creates a legal right in the shareholder, but then fails to apply the remainder of the reasoning in identifying the true source of the legal rights created by the sell-back rights – the true source being the rights carried by the existing shares. Based on the analogous authorities, the sell-back rights could be seen as rights arising from the portion of rights held by a shareholder and the covenant as merely the form of resolution chosen to return capital and ensure that the proportionality of shareholding remained intact.

In addition to finding that the rights arose from the deeds poll, rather than the package of rights encompassed within the existing shares, the High Court took the view that the sell-back rights were separate and detached from the shares and became objects of "commerce." However, it would appear to be arguable from the authorities that trading in rights would not be sufficient to change their character. In *Ord Forest* there is no suggestion in the judgment of Mason J, or in any other of the judgments, that any sale by the shareholders of renounceable rights had, or could have, any bearing on characterisation issues.

10. EXISTING TAXATION PROVISIONS FOR OPTIONS OVER SHARES

Given that the sell-back rights had been identified as on revenue account, this obviated the need for the High Court to direct attention to the provisions of ITAA 1997 which provide that options are specifically included as capital gains tax (CGT) assets. This suggests that there is a legislative intention that the legislative regime explicitly recognises that options are treated as being on capital account. As with most CGT assets, the capital gain or loss provisions would be limited in their application if the asset were a revenue asset, such as trading stock.

In *McNeil's* case the put option was a right in the shareholder to require SBL to buy shares from the shareholder as part of the capital reduction arrangement. Such a put option would be a CGT asset, with nothing in the surrounding circumstances to suggest that the asset could be a revenue asset of the taxpayer.

Under the CGT regime which applies to options, the grant of an option would not generate a capital loss or gain. Any capital loss or gain would occur when the option ceases to exist, either due to exercise of the option, or some other reason.

While CGT event D2 happens when an option is granted, any capital gain or loss made by the grantor of the option will be disregarded if the option is exercised, with the determination of any capital gain or loss for the grantor being determined under

s134-1 ITAA 1997. On the granting of an option, the holder/grantee will have acquired a CGT asset and if the option is exercised, any capital gain or loss on exercise will be disregarded, as the exercise of the option is merged with the disposal transaction, with the capital gain or loss being determined on that transaction.

If an option is not exercised, the relevant CGT event would be event C2, which happens when ownership of an intangible CGT asset ends by being redeemed, cancelled, released, discharged, satisfied, expiring, abandoned, surrendered or forfeited. It is then provided that the capital loss made when an option ends in one of these ways will be the amount paid for the option, together with legal fees. In circumstances where no amount had been paid for the option and the option ends other than by exercise, presumably no capital loss would arise to the holder/ grantee.

This specific CGT regime for the taxation of options, whether or not exercised, suggests a legislative intent that options be taxed as capital assets with a determination of a capital gain or loss as provided under Part 3 ITAA 1997 – and not as income. The exception to the CGT regime – when an option would generate ordinary income – would arise when the options were revenue assets in the nature of trading stock, which

net proceeds of sale had to be determined and the entitlement to those proceeds, of each non-participating shareholder, calculated in accordance with a prescribed

not to be taken as having indicated that receipts which are realizable, but not received, are always derived. In situations which do not relate to trading income, the judge said that there must be something coming in, since "*for income tax purposes, receivability without receipt is nothing.*" [105]

This is illustrated by *Brent v FCT*.[106] In this case the wife of a notorious train robber had sold her life story for a sum of money which was to be paid at certain specified times. The taxpayer accounted on a cash basis. She was assessed to tax on two of the

factual matrix to determine the nature of the receipt. That would have necessitated proper consideration of the circumstances which related to the issue of the sell-back rights. That in turn would have linked the receipt to the reduction in capital which is what the sell-back rights were effectuating.

The Federal Court saw the whole transaction as being on capital account from beginning to end and Callinan J in *McNeil* (dissenting) saw the situation in the same way. Furthermore the authorities –