CASE LAW

WHEN IS INCOME DERIVED?

ARTHUR MURRAY (N.S.W.) PTY. LIMITED v. *COMMISSIONER OF TAXATION OF THE COMMONWEALTH*

Section 25(1) of the Income Tax Assessment Act, 1936-1965 (Commonwealth), provides that the assessable income of a taxpayer shall include "the gross income derived directly or indirectly" from all sources, in the case of a taxpayer resident in Australia, or from all sources in Australia in the case of a non-resident taxpayer. The meaning of the words "income derived" has recently been considered by the High Court of Australia in *Arthur Murray (N.S.W.) Pty. Limited* v. *Commissioner of Taxation of the Commonwealth*.[1]

The Fact Situation

Arthur Murray (N.S.W.) Pty. Limited (the taxpayer), under licence from a United States Company, conducted a business of giving dancing lessons in Sydney and Melbourne. Pupils signed a contract to take lessons usually for five, ten or fifteen hours to be spread over a period of one year, but occasionally for a "lifetime" series of 1,200 lessons. Payments were made either in full on signing the contract or by substantial deposit at that time followed by instalments paid during the course of lessons. Provisions of the contract included: "This contract is entire and not divisible. The student assumes responsibility for the full amount of the tuition set forth herein. No refunds. Non-cancellable contract."

The licence agreement under which the taxpayer conducted its lessons included a provision that the licensee would "at the request of any pupil for a refund when and if a refund is justified" make the appropriate refund. In fact, despite the terms of its contracts with its students, and in conformity with its licence agreement, the taxpayer made certain refunds during the years of income in question in cases where the students who failed to take the prescribed number of lessons gave a satisfactory explanation for discontinuing.

The taxpayer adopted the method of accounting known as the "accruals" or "earnings" method, whereby all the moneys received as advance payments for lessons to be given were not immediately credited to general revenue. Instead, they were credited to an account styled "Unearned deposits — untaught lessons account". As each lesson was given the instructor giving it entered on a record sheet kept by him the name of the pupil, and at the end of each month amounts corresponding to the sums earned by the number of lessons given, as shown by the instructors' sheets, were transferred from that account to an "earned tuition account". Thus the moneys received in respect of lessons yet to be given were not treated by the taxpayer as having been earned until

[1] (1965) 39 A.L.J.R. 262; (1965) 9 A.I.T.R. 673. Members of the Court were Barwick, C.J., Kitto and Taylor, JJ.

the lessons had in fact been given. At the end of each year of income, as a consequence, there were considerable amounts standing in the "unearned deposits — untaught lessons account" to be carried forward to the following year.

The Commissioner of Taxation issued assessments in respect of the years of income ended 30th June, 1954, 1955 and 1956 including as assessable income the amounts actually received by the taxpayer during each of those years, rather than the amounts shown on its accounting system as having been earned. The taxpayer objected to the assessments and, the objection having been disallowed by the Commissioner, requested the matter to be referred to a Board of Review. A majority of the Board found[2] that the cash receipts represented gross proceeds of the taxpayer's business and formed part of its assessable income in the year of receipt thus upholding the assessments, although directing certain deductions with which this note is not concerned.

The taxpayer appealed to the High Court of Australia. Upon the matter coming before Barwick, C.J. his Honour, acting under s. 18 of the Judiciary Act, 1901, stated a case for the opinion of the Full High Court. Question 1 of the case was:

> Whether the Commissioner in the circumstances stated was justified by the provisions of the Income Tax and Social Services Contribution Assessment Act, 1936, as amended, in each respective year in treating as assessable income of the company in its business of a dancing studio proprietor all amounts actually received by the company from students for tuition in dancing as and when the same were received in each of the several years of income respectively ending 30th day of June, 1954, 1955 and 1956, irrespective of whether or not the tuition to which such amounts related was given by the company during the tax year in which such amounts were received.

Other questions were asked, but the Court found it necessary to answer only the first. The answer given was:

> That on the facts appearing in the case stated the conclusion is not open that a receipt of fees for a specified number of dancing lessons to be given over a period subsequent to the receipt is a derivation of assessable income.[3]

Available Law

The scheme of the Australian income taxation legislation provides for taxation of the "taxable income" of the taxpayer, arrived at by ascertaining his "assessable income" and subtracting "allowable deductions". The schemes of income taxation in the United Kingdom and United States, as might be expected in a field in which statutory enactments are so comprehensive, vary considerably and differ from the Australian system. This renders their cases of little assistance in deciding the present question. The Court had, therefore, to rely on the Act and Australian cases in reaching its decision.

Provisions in the Act upon which the Court could rely were found by it to be singularly lacking. In the course of the judgment not one section of the Act was mentioned. Reference was made to the Act not providing any specific test for a case such as the present, and it was stated that in these circumstances the proper guide for the Court was the ordinary business concepts in the community.[4] This proposition will be discussed shortly.

The central question in the case was this: granted that a receipt is otherwise of an income nature, when can that receipt be said to be "income

[2] 10 C.T.B.R.(N.S.) Case 85. Mr. R. E. O'Neill dissented.
[3] (1965) 39 A.L.J.R. 262, 264.
[4] *Ibid.*

derived" by the taxpayer? Upon the answer to this question depends its assessability in one year of income rather than in another. It will readily be seen that the question posed amounts to one aspect of the question, what is income, for to say that an amount received is not "income derived" at the time it is received is to say no more than that it is not yet income at all. This does not, however, assist in a solution to the *Arthur Murray Case*, insofar as the solution is to be found in the Act, since the Act no more defines the term "income" than it does the term "derived".

It was, therefore, necessary for the Court to rely on the general law in determining the question before it.

The case principally relied on by the Court was *Carden's Case, Commissioner of Taxes (S.A.)* v. *Executor, Trustee and Agency Co. of South Australia Limited*.[5] In that case a medical practitioner had furnished his income tax returns on a cash basis of accounting, disclosing as income only those amounts actually received by him during the year of income and not amounts in respect of services rendered by him but not paid to him during that year. It was held that his assessable income included only those amounts actually received during the year of income. Thus in a case in which the cash basis of accounting is used, or at least is properly used, by the taxpayer, his assessable income does not include amounts earned but not yet received by him. On the significance of business principles in deciding the question whether income has been derived, Dixon, J. (as he then was) said:

> Income, profits and gains are conceptions of the world of affairs and particularly of business. They are conceptions which cover an almost infinite variety of activities. It may be said that every recurrent accrual of advantages capable of expression in terms of money is susceptible of inclusion under these conceptions. No single formula could be devised which would effectually reduce to the just expression of a net money sum the annual result of every kind of pursuit or activity by which the members of a community seek livelihood or wealth. But in nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimating or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual, or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in a great measure for the conception of income, profit and gain, and, therefore, may be said to enter into the determination or definition of the subject which the legislature has undertaken to tax. The Courts have always regarded the ascertainment of income as governed by the principles recognised or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question. Familiar but striking examples of this necessary reliance upon commercial principles and general business understanding may be found in the case law dealing with the question whether items should be taken into consideration for any given accounting period rather than that which follows or perhaps for that which preceded.[6]

If this statement is to be accepted as correct law the questions relevant to determining any question of the derivation of income are: 1. Does the Act make any provision in respect of the item claimed to be income? If so, the provisions of the Act determine the question. If not; 2. what is the ordinary practice of business with regard to the item in question?

This conclusion is reinforced by the following dicta of Fullagar, J. in

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[5] (1938) 63 C.L.R. 108.
[6] *Id.* at 152-3.

Federal Commissioner of Taxation v. *W. E. Fuller Pty. Limited*:[7]

> It has often been observed that the Act does not use the word "income" as a precisely defined term of art. What is income and what is not has, when the Act does not speak specifically, to be determined according to general commercial and accounting conceptions.[8]

The conclusion, if such cases stood alone, must be that if general commercial and accounting conceptions dictate that a particular receipt should be treated as income of a particular year, the Act making no contrary provision, that receipt is income of that year.

Against this conclusion, it has been suggested that the words of Dixon, J. in the *New Zealand Flax Case*[9] indicate that even where the taxpayer's accounts are kept on an accruals basis, any cash receipt which has not previously been brought into account as income must be brought in during the year of income in which it is received, whether or not it has then been earned. This conclusion is said to flow from the terms of s. 25 of the Act which provides that the assessable income "shall include . . . the gross income"; the necessity first to determine gross income, it is argued, means that all cash receipts must be brought into account as income. But the words actually used by Dixon, J. were "the assessment must begin by taking, under the name of assessable income, the full receipts on revenue account".[10]

It will be noted that the words used were "the full receipts on revenue account". In view of the provisions of the present Act, which provides (as did the Act of 1922[11] under which the *New Zealand Flax Case* was decided) for initial determination of "assessable" or "gross" income, the words "the full receipts on revenue account" must mean no more than those receipts which are properly regarded as income. This dictum, then, is not capable of adding to the argument for or against the claim to treat a cash receipt as income of the year in which it is received, whatever the accounting system used by the taxpayer.

In the *Arthur Murray Case* the Commissioner relied on *Federal Commissioner of Taxation* v. *Flood*,[12] in which case the Court declined to follow commercial and accounting practice on the question of what constituted a proper deduction from income. However, the Court in the *Arthur Murray Case* pointed out that the reason for rejecting such practice in the earlier case was that the Act laid down a test for determining what was an allowable deduction, and commercial practice could not be allowed to overrule that test. The Act does not lay down a test for what is income. The result of *Flood's Case* may thus be regarded as tending to confirm rather than deny the test derived from *Carden's Case*.[13]

The strongest argument for the Commissioner was without substantial authority. In an earlier case before the Board of Review it had been held, in a situation where millinery lessons were paid for in advance subject to an automatic refund if the lessons were not given, that the receipts were not assessable until the lessons were given.[14] In the *Arthur Murray Case* the Commissioner's argument, and the Board's decision, stressed the element of "automatic" refund in the previous case. That element was missing in the present case, the dancing students having under their contracts with the taxpayer no legal entitlement to a refund, and refunds in fact being made at least infrequently; the Board decided (by majority) that an unconditional

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[7] (1959) 101 C.L.R. 403, 413.
[8] *Id.* at 417.
[9] (1938) 61 C.L.R. 179.
[10] *Id.* at 199.
[11] Income Tax Assessment Act, 1922.
[12] (1953) 88 C.L.R. 492.
[13] *Supra* n. 3.
[14] 15 C.T.B.R. Case No. 2.

receipt, not subject to any sort of trust or contingent obligation to refund the whole or any part, must be income.

Support for this view may be thought to be found in the *New Zealand Flax Case*.[15] In that case moneys were paid by subscribers for the purchase of "bonds" in a company about to undertake a venture of buying land, planting it with New Zealand flax, and subsequently harvesting and reaping it. Ultimate profits of the operation were to be distributed amongst subscribers. Moneys paid for bonds were not loans but were, in effect, payments for services to be rendered in setting up and operating the scheme. There was no restriction on how the company could apply the money, which was paid directly into its revenue account and admitted to be properly treated as revenue, that is as assessable income. The only question argued was, to what extent was it proper to treat the future outgoings in operating the scheme as deductible in the year in which the moneys for the bonds were received. The whole case was conducted on the assumption that the moneys received were assessable income. This does not mean that the assumption was legally justified.

The result of what conflict there may be between *Carden's Case*[16] and the cases supporting it, on the one hand, and the *New Zealand Flax Case*[17] on the other would, on the weight of authority, appear to be in favour of the former. But none of the cases directly decides the question raised in the *Arthur Murray Case*, and support which has been drawn from *Carden's Case* and others is in the nature of a general statement of principles applicable in determining what is income. Income tax cases are notorious for the facility with which the same facts may be made either to fit or not to fit a general test, the result, it sometimes almost seems, being the product of reasons rather beyond the test purported to be applied. Accordingly it might be expected that some refinement is necessary to the principle stated above as flowing from *Carden's Case*. One refinement which suggests itself from the judgment of Dixon, J. in *Carden's Case* itself is that the method of accounting used by the taxpayer will only be significant in determining whether a receipt is income of a particular year if that method is "appropriate". What is the appropriate method of accounting in any particular case is a question of fact, presumably to be determined by evidence of actual commercial practice.

The Decision

This being the state of authority, the Court was able in the *Arthur Murray Case* to approach its decision unhindered other than by fairly general principles referring to accounting practice and business principles in determination of the income nature of a receipt. In the result the Court sanctioned the use of accounting practice, though perhaps, in theory at least, limiting its significance.

As has been mentioned, the Court found no specific section of the Act to rely on. Further, it relied only on one case, *Carden's Case*. And even then the Court rather explained that decision than relied upon it. It was pointed out that *Carden's Case* involved a question whether an amount earned but not yet received was income, and that in the *Arthur Murray Case* the question was in a sense the reverse: whether an amount received but not yet earned was income.[18]

The Court went on to quote the words of Dixon, J. in *Carden's Case*: "Speaking generally, in the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in

[15] *Supra* n. 8.
[16] *Supra* n. 4.
[17] *Supra* n. 8.
[18] (1965) 39 A.L.J.R. 262, 263.

a realised or immediately realisable form";[19] and, having quoted these words, then had to explain that by "gains" his Honour meant neither nett profits nor gross receipts, but gross income, that is, amounts which have been not only received but also earned.[20] A further use of *Carden's Case* as a parallel, without outright reliance on the case, is to be found when the Court went on to say:

> In determining whether in such a case (as *Carden's Case*) actual receipt had to be added to earning in order to find income, uncertainty of receipt, inherent in the circumstances of the earning, appeared to his Honour, (Dixon, J.) to be decisive. Likewise, as it seems to us, in determining whether actual earning has to be added to receipt in order to find income, the answer must be given in the light of the necessity for earning which is inherent in the circumstances of the receipt.[21]

Carden's Case was also referred to on the question of the significance of accounting principles in determining whether income is derived, and again the Court found it necessary, in a way to be discussed below, to explain the statement of Dixon, J. on that point.

Apart from *Carden's Case*, the only Australian case referred to was *Federal Commissioner of Taxation* v. *Flood*,[22] and as pointed out above, the case was mentioned only to be distinguished. Also mentioned and dismissed was a United States case, *Schlude* v. *Commissioner of Internal Revenue*.[23] The Court thought that the latter case could not assist its decision because of differences in the United States and Australian tax law. *Schlude's Case*, however, is not without interest in the present situation. That case also involved the holder of an Arthur Murray franchise and raised the same question as that before the Court, namely whether fees received in advance of lessons were taxable in the year of receipt. A narrow majority of the Supreme Court in giving an affirmative answer relied principally upon the rather peculiar legislative history of provisions of the United States Internal Revenue Code which are without parallel in Australia.

This was the extent of reference to authority in the *Arthur Murray Case*.

The Court's decision was brief and, in discussing it, it is convenient to summarise the reasoning applied. It was first pointed out that the Court was concerned with the concept of "income",

> . . . and that must surely involve, if the word "income" is to convey the notion it expresses in the practical affairs of business life, not only that the amounts received are unaffected by legal restrictions, as by reason of a trust or charge in favour of the payer — not only that they have been received beneficially — but that the situation has been reached in which they may properly be counted as gains completely made, so that there is neither legal nor business unsoundness in regarding them without qualification as income derived.[24]

The question for decision, the Court went on, was whether the receipt was enough by itself to satisfy the general understanding among practical business people of what constitutes a derivation of income. In deciding what that understanding is, standard accountancy methods may assist but are not conclusive; they are but evidence of the concept of income, which is a concept to be determined by a judicial decision as to what the word conveys to those whose concern it is to observe the distinctions it implies. In the present case a necessity for earning was inherent in the circumstances of the receipt, whether or not the amount received became the beneficial property

[19] (1938) 63 C.L.R. 108, 155.
[20] *Id.* at 263.
[21] *Id.* at 263.
[22] (1953) 88 C.L.R. 492.
[23] (1963) 372 U.S. 128.
[24] *Id.* at 263.

of the recipient, as in fact it did. There remained, from a business point of view, the contingency that some of the amount received might have to be paid back, even if only by way of damages, should the taxpayer not ultimately perform its part of the bargain. This possibility was an inherent characteristic of the receipt and made it unreal to regard the receipt as having the quality of income.

This view was supported by established accountancy and commercial principles which had been stated as an agreed fact in the case stated. According to the principle so stated, money received as a prepayment for goods or services is not properly to be regarded as income until the goods are delivered or the services are rendered. The Court saw no reason to differ from accountants and commercial men. In the absence of a controlling statutory definition, the concept of income was "to be understood in the sense which it has in the vocabulary of business affairs".[25] It followed that income was not derived at the point of time when the fees had been received by the taxpayer.

Evaluation

Some points on which comment might be made are on the distinction drawn between business concepts and accounting procedures, and the significance of each in the determination of whether income has been derived, and the significance of the contingency that money received may have to be repaid.

It will be seen from the judgment that in some circumstances the Court may be faced with a situation in which the Act, business concepts and accountancy procedures provide different and inconsistent tests as to whether an amount received is income. In this situation the case indicates that the statutory test must predominate over either of the other two (to this extent agreeing with Dixon, J. in *Carden's Case*). Where the Act makes no specific provision (as in the *Arthur Murray Case* itself) then business concepts are *conclusive* on the question of "income" in such a situation — or rather the legal concept of "income" is conclusively determined by the business concept. Accountancy practice, in a case where the Act makes no relevant provision, may be admitted as evidence of what is the business concept, but accountancy methods can never be more than *prima facie* evidence. In *Carden's Case*, Dixon, J. had not made a clear distinction between business concepts and accounting principles, and on this point the judgment in the *Arthur Murray Case* would appear at least to place different emphasis on the significance of each of the tests in question.

It is submitted that the result in the *Arthur Murray Case* on this point should be regarded as correct if for no better reason than that of convenience. Income taxation is largely concerned with affairs of business in the broad sense, and the term "income" is a business concept which reflects the usages and attitudes of practical businessmen. It is appropriate that the legal concept of income should be determined by business considerations exclusively. Any disturbance of this harmony between the legal concept and the business concept would tend to divorce the law from its subject-matter. Accounting practices and principles on the other hand are only evidence of business concepts and do not themselves constitute a test of income.

In the case the Court made an effort to find some contingency to indicate that the money received was not received absolutely by the taxpayer. It had to be admitted that there was no contractual liability to pay back the whole or any determinable part of the moneys in the event of the students failing to take the future lessons. Rather the Court found the contingency in the possibility of an action in the future for damages if the company failed to give the lessons contracted for — that is, as a matter of business practicality,

[25] (1965) 39 A.L.J.R. 262, 264.

it appears, a taxpayer should contemplate the possibility of his own future breaches of contract. While the possibility remains it is not, as a matter of business good sense, appropriate to treat the amount received as income. The reasoning is hardly acceptable even if the conclusion is desirable. It would, for example, be interesting to learn whether, in a case of payment for goods sold and delivered, the seller is entitled to argue that no income is derived because of the contingency of an action should the goods prove to be defective. And in the *Arthur Murray* situation, in the event of the taxpayer failing to give the lessons contracted for, should it retain the moneys received in reserve until the period of the Statute of Limitations expires? It would appear that the discussion of the contingency aspect was not necessary to the decision, which could have rested on business practice. What the Court was trying to do, it seems, was to explain that business practice, and in so doing it created an unnecessary difficulty for itself. It should have gone no further than the terms of the case stated, which, by setting out affirmatively what business practice was, prevented the Court from considering the question whether it does in fact accord with business usage to consider an amount received unconditionally as not immediately being income derived.

The result, then, is a confirmation of business practice as the test in situations arising under the Income Tax Assessment Act, 1936-1966, where the Act lays down no test for those situations. The decision is important for the business community as it affirms the legal basis of the common business practice of deferring "unearned" income where it is appropriate to do so. By inference, it reassures the businessman that the Courts are ready to pay heed to business conventions when allowed by the legislature to do so.

Footnote

In the light of this decision by the High Court, the Commissioner has announced that it will be applied in the majority of instances in future.[26] Interesting questions might arise as to receipts included in assessments for previous years, and "earned" in future years; are they to be taxed anew when earned?

S. J. FERGUSON, Case Editor — Fourth Year Student

PREINCORPORATION CONTRACTS

BLACK AND ANOR. v. *SMALLWOOD AND ANOR.*[1]

Black v. *Smallwood* is an application and possibly a development of the principles enunciated by the English Court of Appeal in *Newborne* v. *Sensolid*.[2]

The plaintiffs, as vendors of certain lands situate at Campbelltown, signed a document in the form of the 1953 edition of the conditions and terms of sale approved by the Real Estate Institute of New South Wales. Where the form of contract provided for the signature of the purchaser, there were the words "Western Suburbs Holdings Pty. Limited" and, underneath, the signatures

[26] 9 *The Taxpayers' Bulletin* No. 14 at 4, where full details are set forth.
[1] (1966) 39 A.L.J.R. 405.
[2] (1954) 1 Q.B. 45.