CASE LAW
LAND DEVELOPMENT: INCOME OR CAPITAL?

COMMISSIONER OF TAXATION (CTH.) v. WHITFORDS BEACH PTY. LTD.[1]

Introduction

When a company acquires land and over a period of time extensive work is done on it, it is sometimes difficult for the court to decide whether sale of the land or part of it is a realization of a capital asset or a business of land development. Further, if the court decides that the transaction is taxable, it is not clear under which provisions of the Income Tax Assessment Act 1931 the transaction is caught. *Whitfords Beach* has thrown some light on these matters.

The Facts

In 1954, Whitfords Beach (the taxpayer) acquired a large parcel of land north of Perth. The land was acquired to secure for the original shareholders of the company access to shacks which they occupied on the beach front and not for the purpose of profit-making by sale or for any business purpose. On 20th December, 1967, the then shareholders sold the entirety of their shares to three purchasers who were acting together. On the same day, a new set of articles was adopted by the taxpayer and two of the purchaser companies were appointed to be general managers. They were to do all within their power to develop and subdivide the land and to sell it in subdivisional allotments. Thereafter, the managers began to carry out work on the land on a massive scale (including a search for a source of water supply and investigation of means of providing essential services). Progress accelerated in 1969 when the government of Western Australia, for reasons of policy, began to encourage and support the subdivision of land in the district. In 1970, subdivision of a portion of the land commenced. In the following years, substantial sums were received by the taxpayer as the proceeds of sale of allotments. The Commissioner contended that the events which occurred on 20th December, 1967 marked a decisive change in the character and purpose of the taxpayer and that since that date, the sole object of the taxpayer was to engage in the business of development, subdivision and sale of the land.

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[1] (1982) 56 A.L.J.R. 240; this case is discussed by L. J. Priestley, "Business Gains and Casual Gains After Whitfords Beach" *Developments in Tax Law Series* II, a lecture series of the Committee for Postgraduate Studies in the Department of Law, University of Sydney, 1982.

At First Instance[2]

Wickham, J. concluded that the taxpayer was as from the crucial date "carrying on the business of subdividing, developing and selling land as lots for residential or auxiliary purposes and was doing so with a view to profit" (the profit being assessable income within s. 25) and that it was not a borderline case between capital and income.[3]

The Federal Court[4]

The Federal Court by majority (Brennan and Fisher, JJ. with Deane, J dissenting) upheld the taxpayer's appeal. The majority thought that both s. 25 and s. 26(a) were not applicable. However, Deane, J.[5] thought that "the proceeds of the sales of subdivided lots should properly be seen as representing profits made in the ordinary course of what [was] in truth a business", and his Honour was "quite unable to see the planned and systematic activities upon which the taxpayer embarked on 20th December, 1967 other than as constituting business."

The High Court Judgments

The High Court considered three issues on appeal:

(1) whether there was a business of land development (viz. ordinary usage concepts of income);
(2) the application of s. 26(a);
(3) the relationship of s. 26(a) and s. 25.

The High Court unanimously held that what the taxpayer did was more than advantageous realization of a capital asset, that its activities constituted a business of land development. The transaction, therefore, gave rise to assessable income.

Section 26(a) — First Limb

To invoke the first limb there must be (1) a profit, (2) arising from the acquisition and sale of the same property, and (3) a dominant profit-making purpose. Thus in *McClelland* v. *F.C.T.*,[6] where the taxpayer who had inherited an undivided half-share of land as tenant in common with her brother, later purchased her brother's half-share and sold the greater part of the land in order to finance the purchase, the Privy Council held that the first limb did not apply because the nature of the property sold (a whole interest) differed in kind from the nature of the property acquired (the interest of a tenant in common). The taxpayer did not acquire the original half interest with the necessary purpose because that was an unsolicited gift under a will. The profit-making purpose, which must exist at the time of the acquisition of the property, need not be the sole purpose as long as it is the "dominant purpose". Mason, J. in *Whitfords Beach* regarded this as a settled interpretation of the first limb.[7]

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[2] 78 A.T.C. 4211.
[3] *Id.* 4216.
[4] 79 A.T.C. 4648.
[5] *Id.* 4665-6.
[6] (1970) 120 C.L.R. 487.
[7] *Supra* n. 1 at 250.

Likewise, Gibbs, C.J. thought that the first limb had no application to *Whitfords Beach* because:

> . . . the property sold, the land was not acquired by the taxpayer for the purpose of profit-making by sale, although the shares in the taxpayer were acquired by the present shareholders for the purpose of making a profit by the sale of the land.[8]

In short, *Whitfords Beach* has confirmed the identity principle (because the profit-making purpose attached to the acquisition of the shares, not the land which was sold) and the dominant purpose interpretation.

Section 26(a) — Second Limb

The Distinction between the Second Limb and the Carrying on of a Business

The second limb is concerned with the question: what is a "profit-making undertaking or scheme"? Murphy, J. was the only member in *Whitfords Beach* who held that the land development scheme fell within the second limb. His Honour said that:

> . . . The development involved not only subdivision, but planning and building of road and other services, as well as other activities involved in modern land development schemes, and it was undertaken for profit-making. This is not a borderline case. It is altogether different from, for example, a simple realisation of a large allotment by subdivision into several smaller blocks.[9]

His Honour did not consider the alternative of a business, but he stated that the transaction came within s. 26(a). Therefore, Murphy, J.'s judgment does not necessarily preclude other views.

Mason, J. referred to *Official Receiver* v. *F.C.T. (Fox's Case),*[10] where the Full High Court stated that:

> . . . although s. 26(a) is founded on language which was used in judicial decisions . . . yet it provides a statutory criterion which must be applied directly and cannot be treated as going no further and producing no different result than would a criterion expressed as "exercising trade" or "carrying on a business".[11]

Mason, J. thought that the important point made in *Fox* was that the language of the second limb should be interpreted directly and that it should not necessarily be constrained by reference to what had been said in earlier cases, and that *Fox* was also significant in that it merely denies the proposition that the second limb contemplates an undertaking or scheme involved in "exercising trade" or "carrying on a business" (that is, a continuing business). *Fox* did not deny that the second limb contemplates a "business deal" or "business operation".[12] That is, a one-off operation must

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[8] *Id.* 244; comments of Gibbs, C.J. in *Steinberg* v. *F.C.T.* (1975) 134 C.L.R. 640 applied.
[9] *Supra* n. 1 at 252.
[10] (1956) 96 C.L.R. 370.
[11] *Id.* 387.
[12] *Supra* n. 1 at 249.

have some business characteristics and the notion of "business deal" is implied into the second limb. It is clear that Mason, J disliked *McClelland.* His Honour thought that there were two separate strands of thought embedded in the majority's observations in *McClelland*:

> . . . (1) that the transaction must have about it some business or commercial flavour — the purchase of an investment by a private investor is not enough, and (2) the profit in view must be an income not a capital gain according to ordinary concepts.[13]

Mason, J. concluded that an undertaking or scheme may be a profit-making one even if it lacks the characteristics of repetition or recurrence which are supposedly essential to the carrying on of a business.[14] Therefore, in appropriate circumstances, when an individual engages in activities with business characteristics, although they do not amount to a business, those activities (carried on in relation to land) may come within the second limb of s. 26(a) even though the land was not purchased with a profit-making purpose. Mason, J. had difficulty with the *McClelland* conclusion, in relation to the second limb of s. 26(a), that what had occurred was a mere realisation of an asset. The majority in *McClelland* failed to differentiate between the English and Australian systems of taxation.[15] Furthermore, his Honour referred to the possibility that the case "insufficiently acknowledges that the operation of the second limb of s. 26(a) may extend to some gains of a capital nature according to general revenue law".[16] For example, Menzies, J. in *Investment and Merchant Finance Corporation Ltd.* v. *F.C.T.*[17] said that:

> . . . section 26(a) deals with particular transactions which might otherwise escape from the tax net and it brings into assessable income, profits, after outgoings attributable to the particular transaction have been taken into account.[18]

The conclusion of Mason, J. seems to be that some element of a business nature is necessary for the second limb of s. 26(a) but that it need not be very much and is not confined to ordinary usage concepts in that regard.

In deciding whether the transaction gave rise to income within ordinary concepts, Gibbs, C.J. would ask: was what was done merely a realisation of the taxpayer's asset, or was it something done in what was truly the carrying out of a business?

> If the taxpayer does no more than realize an asset, the profits are not taxable. It does not matter that the taxpayer goes about the realization in an enterprising way, so as to secure the best price.[19]

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[13] *Ibid.*
[14] *Supra* n. 1 at 251.
[15] For example, in *Fox, supra* n. 11, the High Court thought that the English cases cannot govern the application of s. 26(a), although they may give some assistance.
[16] *Supra* n. 12.
[17] (1971) 125 C.L.R. 249.
[18] *Id.* 264.
[19] *Supra* n. 1 at 244.

For example, in *F.C.T.* v. *Williams*,[20] the landowner acted on expert advice as to the best subdivision, and carried out work such as grading, levelling, road building and the provision of reticulation for water and power. What was done to the land was merely advantageous realization. However, if the landowner had started to build houses on the land he would have gone into land development and he would have been caught by s. 26(a).

The are two strands of judicial comments concerning *Scottish Australian Mining Co. Ltd.* v. *F.C.T.*[21] and *Fox*, in *Whitfords Beach*. In *Scottish Australian Mining*, the taxpayer was originally a coal mining company. After it had ceased its coal mining business, the company subdivided land which it had previously purchased (including construction of roads and a railway station and making sites available for essential amenities). As a result, considerable profit was made on sale. It was held that the profit was not assessable income. Williams, J. thought that it was "simply part of the process of realizing a capital asset".[22] The case was like *Whitfords Beach* in the sense that, at the time of the acquisition of the land, the company was not in the business of dealing in land.

In *Fox*, the official receiver commenced afresh the land development which had been begun by the bankrupt. *Fox* may be contrasted with *Scottish Australian Mining* in that in *Fox*, there was a business of land development originally, it had ceased and a new transaction came into existence, while in the *Scottish Australian Mining Case*, there was no business of land development at first, and then activities were done on the land, which may have been taxable. Whether this distinction on the facts should produce a different result may be doubted.

The Full High Court in *Fox* held that the profit fell within s. 26(a) because "the activities were planned, organized and coherent . . . to yield net proceeds considerably in excess of what otherwise could be obtained".[23] Gibbs, C.J. thought that *Fox* was difficult to comprehend and if the ratio of *Fox* was that the fact that activities were planned and organized converted an advantageous realization into a profit-making scheme, it could not stand with other authorities. His Honour thought, perhaps *Fox* could be explained on the ground that it went beyond mere realization.[24] On the contrary, Mason[25] and Wilson,[26] JJ. thought that the *Scottish Australian Mining Case* was difficult to comprehend. Mason, J. said that the only difference between the two cases seemed to be that there was a new taxpayer in *Fox*.[27]

In the result, Gibbs, C.J., Mason and Wilson, JJ. held that the activities of the taxpayer in *Whitfords Beach* were truly a business venture,

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[20] (1972) 127 C.L.R. 226.
[21] (1950) 81 C.L.R. 188.
[22] *Id.* 195.
[23] *Supra* n. 11.
[24] *Supra* n. 1 at 245.
[25] *Id.* 252.
[26] *Id.* 258.
[27] *Fox* is said to be exceptional, for example in *Williams, supra* n. 20 per Gibbs, C.J.

and the profits were income within ordinary concepts. Their comments on the content of s. 26(a) are, therefore, strictly *obiter.*

Purpose in s. 26(a)

Since the taxpayer was a company, it was necessary to attribute the business purpose to those who control the company. Gibbs, C.J. held that the events on 20th December, 1967 were crucial. It transformed the company into one whose purpose was to engage in a commercial venture with a view to profit. The purposes of those who control the company are its purposes: *Tesco Supermarkets Ltd.* v. *Nattrass.*[28] The three companies which became shareholders represented the directing mind and will of the taxpayer and controlled what it did, and their state of mind was the state of mind of the taxpayer. Likewise Mason, J.[29] said that the intention of the company was to be ascertained by reference to the intention of those who owned and controlled it at the relevant time and Wilson, J.[30] thought that there was enough in the changes in the company's constitution and the contract into which the taxpayer entered to signify the launching of a business of developing, subdividing and selling the land. The High Court applied the organic theory of the company. The theory recognizes the corporate entity and merely seeks to identify the motive or purpose of the corporation when (as often) it is legally necessary to do so.

As regards the two limbs of s. 26(a) and purpose, Mason, J. said that whilst the first limb speaks of a dominant purpose, the second limb does not speak of purpose. If the second limb looks to dominant purpose, it is to the dominant purpose of "profit-making by sale". There is a fruitful field for the operation of the second limb in cases where there is a lack of identity between the property acquired and the property sold.[31] His Honour's approach may be contrasted with the approach of Gibbs, J. and Jacobs, J. in *Macmine* v. *F.C.T.*[32] (a case concerning an option to purchase shares), where their Honours stated that in ascertaining the purpose for the second limb, the inquiry is the same as for the first limb. One inquiry is no more or less subjective than the other and the rule as to the onus of proof operates in the same way in both cases.[33]

The writer suggests that these two approaches are not necessarily inconsistent; they are merely expressions of opinion on different matters. In *Macmine*, their Honours spoke of primary (dominant) purpose for both limbs, assuming the existence of an appropriate profit purpose while Mason, J. in *Whitfords Beach* was discussing what kind of purpose is needed for the two limbs, assuming the dominant purpose has been identified.

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[28] [1972] A.C. 153 at 171, 187.
[29] *Supra* n. 14.
[30] *Supra* n. 1 at 258.
[31] *Supra* n. 7.
[32] (1979) 53 A.L.J.R. 362.
[33] *Id.* 367, 376.

The Relationship between s. 25, s. 26(a) and the Concept of Income Generally

To what extent do these sections overlap and to what extent are they mutually exclusive?

Ordinary Usage and the Second Limb of s. 26(a)

Gibbs, C.J. thought that if the words of the second limb are literally construed:

> . . . they are wide enough to include profits which are income according to ordinary concepts as well as profits of a capital nature. In so far as they include profits which are income in character they appear to overlap to some extent the provisions of sec. 25(1).[34]

In *White* v. *F.C.T.*[35] (a case concerning the sale of standing timber) Taylor and Owen, JJ. thought that whether the case fell within the second limb, or whether according to ordinary concepts the sum was income in the taxpayer's hands, were related questions and their Honours considered them together. Gibbs, C.J. in *Whitfords Beach* also thought that it is established that profit yielded by the mere realization of a capital asset not acquired for the purpose of profit-making by sale would not be assessable income either on ordinary usage notions or as the profit arising from the carrying on or carrying out of a profit-making undertaking or scheme within s. 26(a). There is no doubt that when particular transactions (for example, the buying and selling of stock in trade) which might otherwise fall within s. 26(a) form part of the conduct of a wider business, it is not permissible to treat each such transaction as separately taxable under s. 26(a).[36] As Barwick, C.J. said in *Investment and Merchant Finance:*

> . . . it is an error . . . to think that the transactions of a business can be taken item by item and each treated as falling within s. 26(a). The business must be regarded as a whole, its receipts being assessable income from which the permitted deductions are to be deducted.[37]

The writer finds the borderline between ordinary usage and s. 26(a) hard to draw. Why was *Fox* a s. 26(a) case and *Whitfords Beach* an ordinary usage case? Their facts were very similar and judges seem to apply similar criteria to each. For the purpose of considering the relationship of the sections of the Act, it will be assumed there is a meaningful distinction between the two areas.

Gibbs, C.J.[38] and Mason, J.[39] thought that s. 26(a) will only operate when s. 25(1) does not. Further, Mason, J. said that the activity of the taxpayer constituted the carrying on of the business of land development and the gross income is assessable under s. 25(1). But alternatively, the activities would be a profit-making undertaking or scheme and the net

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[34] *Supra* n. 1 at 242-3.
[35] (1969) 43 A.L.J.R. 26.
[36] *Supra* n. 1 at 243.
[37] *Supra* n. 17 at 254.
[38] *Supra* n. 19.
[39] *Supra* n. 14.

profit would have been assessable under s. 26(a). Their Honours applied what was said in *F.C.T.* v. *Bidencope*[40] where Mason, J. in that case said that the second limb of s. 26(a) applies only to "profits not attributable to gross income that has already been captured by sec. 25". Thus, we have come to a point that there is authority to treat s. 25 and s. 26(a) as being mutually exclusive and never operating together. In other words, they treat s. 25 as embodying ordinary usage notions of income only, and other items as entering assessable income directly through other provisions of the Act.

There are two analyses[41] which can be distinguished on the relationship of s. 25 to other specific provisions of the Act. The first view is that the items which are caught by s. 25(1) are only those transactions which are income according to ordinary usage concepts. On this view other items of income enter the tax net through specific provisions of the Act, where "assessable income is specifically described", for example, s. 26 (this has been called the *Parallel Provisions Analysis*). This view suggests that "income" has two meanings in the Act. First, it means income according to ordinary usage. Secondly, income is to be interpreted as meaning "assessable income", that is, the amount from which allowable deductions are deduced to bring out the amount of taxable income (the *Two Meaning Analysis*).

The second analysis of the law has been supported by Professor Parsons. He considers that income can only ultimately come into "assessable income" via s. 25(1) (the *Central Provision Analysis*). This view suggests that the word "income" has only one meaning. This meaning is found by reading together all the provisions of the Act (the *Single Meaning Analysis*). That is, ordinary usage income and specific provisions all enter the tax net through s. 25. If a specific provision (such as s. 26(a)) covers the field, to that extent it does away with ordinary usage concepts of income but it does not thereby limit s. 25 on this view. There is no need for s. 25 and s. 26(a) to be mutually exclusive.

Whitfords Beach clearly adopts the parallel provisions analysis since the case decided that income can *either* come through s. 25(1) *or* s. 26(a), and not ultimately through s. 25(1) if it falls within s. 26(a). The difference between the two views is not significant on the facts — as already demonstrated, the difficult problem raised but not answered is the border line between ordinary usage and s. 26(a).

Calculation of Profit

Whitfords Beach is unfortunate in the sense that the calculation of the amount to be brought to tax under s. 25(1) was remitted to the Federal Court for consideration. Thus, the High Court has cast no light on this aspect. In summary, there are three alternatives to calculate profit.

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[40] (1978) 140 C.L.R. 533.

[41] R. W. Parsons, "The meaning of Income and the Structure of the Income Tax Assessment Act" (1978-9) XIII *Taxation in Australia* 378, and specifically on s. 25 and s. 26(a) at 399-400.

(1) *Proceeds of sale — Gross Receipts Assessable*

By this method, the gross receipts are assessable income and the taxpayer is left to reduce taxable income to the level of his profit by claiming allowable deductions. In *Whitfords Beach*, the problem of this analysis is that the taxpayer could not claim a deduction originally because there was no business. Later, when the business of land development had started, it could have claimed some deduction, for example, the cost which went into the development, but the taxpayer had not apparently claimed these amounts as deductions in the year of expenditure (taking the view that the receipt would not be assessable) and if a claim is not made in the appropriate year, it cannot thereafter be made. With this method it is impossible to satisfactorily bring an appropriate amount to tax. This method is only appropriate, if at all, in an ordinary usage situation. It cannot apply to s. 26(a) which refers to "*profit* arising".

Gibbs, C.J.[42] in *Whitfords Beach* acknowledged that there may be cases in which a different result will be arrived at depending on whether s. 25 or s. 26(a) was applied. His Honour was not persuaded that a difference will result from the fact that s. 25(1) refers to "gross income" and s. 26(a) refers to "profit". Mason, J. thought that:

> . . . Because sec. 26(a) looks to net profit and sec. 25(1) deals with gross income, different consequences may follow, according to which provision is found to apply to a taxpayer. In ascertaining net profit for the purpose of sec. 26(a) general accounting principles, rather than the statutory provisions relating to allowable deductions may need to be applied. In the result in a given case there may not necessarily be a correspondence in the operation of sec. 25(1) and sec. 26(a).[43]

It should be noted that Mason, J. thought that profits may also come in under s. 25. That is, s. 25 is not limited to gross receipts. (There are deductions from gross income under s. 51 on the gross receipts basis as already explained whilst for net income, all that is assessable is the profit.) In *Rowe* v. *F.C.T.*,[44] Menzies, J. held that s. 25 only concerns gross receipts, and not net receipts. His view has been rejected by *Whitfords Beach* and other authorities but the Courts have yet to make clear where a gross receipts calculation applies and when a net receipts approach is appropriate.

(2) *Trading Stock*

Land can be trading stock even where it is the sole asset of a company and its development the sole object of the company. This is clear from *St. Huberts Island*.[45] Although it has been held that an asset when once it becomes trading stock for the purposes of the Act does not cease to be such simply because the business ceases, the converse is not true and an asset which is purchased as a capital asset can become trading stock when

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[42] *Supra* n. 36.
[43] *Supra* n. 7.
[44] (1971) 124 C.L.R. 421.
[45] (1978) 138 C.L.R. 210.

ventured as such in a business. In *Murphy* v. *F.C.T.*, Kitto, Taylor and Windeyer, JJ. in a joint judgment, held that trading stock never lost its character.[46] When a party ventures a capital asset as trading stock in a trading situation he should receive as his opening debit, the value of the asset at the time he hazards it into the trade. There is no expenditure of money at this time and the calculation may be referred to as a "free debit". This converse situation was precisely what had happened in *Whitfords Beach.* When the land was acquired it was a capital asset. On the crucial date, it was transformed to trading operations.

When an asset becomes trading stock but is not purchased (e.g. a gift) or is purchased but not as trading stock (as in *Whitfords Beach*), then a deduction is received on its becoming trading stock of the market value of the asset at the time it becomes trading stock. On this approach, at the instant of change of purpose, the land becomes trading stock of a land development business. The way to make the trading stock provisions work in such a case is the "free debit" method as in *Curran* v. *F.C.T.*[47] (a case concerning receipt of shares as a bonus). Gibbs, J. there said in relation to a gift:

> In my opinion it was not possible to arrive at the appellant's true income without taking the bonus shares into account as trading stock acquired, whether or not those shares could properly be regarded as having been purchased. The appellant's trading account would not reveal the real situation if it brought in at no value shares which were in fact valuable, because the amount which it would then show as income would include the value which the shares possessed when they were first brought into stock. The case may be compared with that of a trader who takes into his trading stock articles which he received by way of gift or under a bequest. Cases of that kind not falling within sec. 36 of the Act may be rare, but they can be envisaged. In such a case an account will not reveal the true result of the trading unless those articles are brought in at an appropriate value, e.g. market selling value. If the account showed that the articles cost nothing, the result would be to increase the amount of the trader's profit or decrease the amount of his loss by the value of the gift or bequest and in effect to make the trader pay income tax on the gift or bequest. The only practicable way of reaching a true result in a case of that kind would be to bring the articles into the account at an appropriate value as though they had been purchased, and there is no provision in the Act that would require any different approach.[48]

A similar principle applies to s. 26(a) where a profit-making scheme is commenced. In *McRae* v. *F.C.T.*, [49] Kitto, Menzies and Owen, JJ. discussed the taxpayer's attacks on the method by which the Commissioner

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[46] Raphod, "Trading Stock — Can it change its character" (1982) XVI *Taxation in Australia* 682 citing *Murphy* v. *F.C.T.* 106 C.L.R. 146 as authority.

[47] (1974) 131 C.L.R. 409; *Curran* has been overcome by *Income Tax Assessment Act* 1936 (Cth.) s. 6AB.

[48] *Id.* 421.

[49] (1969) 121 C.L.R. 266.

has reached the conclusion that the proceeds of the sales of shares included an element of profit. Their Honours stated:

> The second question comes to this: in ascertaining whether the scheme has yielded a profit, is it right to include in the amount from which the cost of the scheme is to be deducted the proceeds of the sale of the bonus shares, that is to say the shares that were issued as fully paid by the application of the dividend declared out of the amount standing to the credit of the assets revaluation reserve account? And the third question is: if so, ought the amount of the dividend so applied to be taken into account as part of the cost of the scheme? . . . In the first place it is beyond dispute that the proceeds of sale of all the shares sold, both original and bonus shares, must be brought to account in order to find the gross amount which the carrying out of the scheme produced. And in the second place the notion that the dividend formed a part of what the children put into the scheme in order to get the gross proceeds out of it overlooks the fact that the declaration of the dividend had the effect of subtracting an equal amount from the value of the original shares, so that the entire transaction consisting of the declaration of dividend plus the crediting of the bonus shares as fully paid had no other effect than that of a transfer of part of the value of the original shares to the bonus shares. . . .[50]

The relationship between s. 26(a) and s. 51 has been considered by Menzies, J. in *Investment and Merchant Finance* where it was said:

> The taxable income of a business is to be ascertained by deducting allowable deductions from assessable income, and in the calculation of assessable income regard must be had to many considerations to be found specified in the Income Tax Assessment Act, such as all the appropriate items set out in s. 26; the requirement that trading stock on hand at the beginning of the year of income and at the end of the year of income must be brought into account; to the allowance of depreciation; to the deduction of bad debts; to past losses . . . . Outgoings made in earning a profit which is assessable income by virtue of s. 26(a) are not outgoings for the purposes of s. 51. There is no profit from a scheme to be included in assessable income until such outgoings have been taken into account. In most cases items of assessable income are gross receipts; a profit which is assessable income by virtue of s. 26(a) is a net receipt.[51]

When an asset is in fact trading stock but has not been treated as such in a trader's accounts (for business or tax purposes), he is still only taxed on profit on sale because balancing items at the end of each year effectively cancel out the deduction until sale, that is, no change is produced in earlier years' tax accounts whether or not deductions were claimed.

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[50] *Id.* 231, and likewise in *Bernard Elsey* v. *F.C.T. per* Windeyer, J. (1969) 120 C.L.R. at 110.

[51] *Supra* n. 18.

In *Investment and Merchant Finance,* it was accordingly held that it did not matter that the taxpayer had not applied the accounting of the trading stock provisions to shares which were held to be trading stock. Menzies, J. stated:

> When the Act provides a method for the ascertainment of the value of stock in trade for the purposes of determining assessable and taxable income (ss. 28 and 31) it does not go further and require that the taxpayer's profits should be determined in the same way for commercial purposes or require the taxpayer's taxation return to accord with its commercial accounts.[52]

And later Walsh, J. considered:

> If the appellant had compiled its returns on the basis that the shares were trading stock, as in my opinion they were, it would have been entitled to take into account their value at 30th June 1964, either at their cost price or at their market selling value: see s. 31 (1). The appellant did not compile its returns in accordance with the provisions of ss. 28 and 31. But what it did was not for practical purposes productive in that year of a result more favourable to the appellant than the result which would have been obtained if those provisions had been then applied. For taxation purposes, in that year it did not treat itself as having suffered any loss by reason of the fall in the value of the shares which was the consequence of the payment of the dividend. It treated itself as still having shares worth the amount which it had paid for them. The dividend it received came into its income for that year.
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> When the year which ended on 30th June 1965 is considered from the point of view of the application of ss. 28 and 31, that year could be regarded as having opened with trading stock in which were included the Macgrenor shares valued at cost. It could be regarded as having closed with trading stock which did not include those shares, which had been sold in that year. So far as that component in the trading stock was concerned, the result would be that the cost-price value of the shares would be deducted from the taxable income. The small sum received upon their resale would be of course an income item for that year. The result which I have stated would be in no way affected by the fact that a large dividend had been received in the previous tax year upon the Macgrenor shares.[53]

Therefore, the trading stock method can apply to the taxpayer in *Whitfords Beach* to tax only profit. Costs of the taxpayer incurred after business started are deductible, but are absorbed into the cost of trading stock, and because of the balancing items at the end of each year for closing stock, the deduction is effectively postponed until sale.[54]

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[52] *Id.* 266.
[53] *Id.* 271.
[54] See e.g., *Philip Morris* v. *F.C.T.* 79 A.T.C. 4352.

(3) *Revenue Asset*

In the situation where land is a revenue asset and not trading stock, only the profit is assessable. This solution is the simplest method.[55] Thus, in *Whitfords Beach* only the profit would have been taxable, and presumably calculated on similar principles to s. 26(a).

Conclusion

There is no doubt that there will be more development in this area of the law. As Wilson, J.[56] said in *Whitfords Beach*, "further elucidation should await a case which depends on the provisions [26(a)] for its determination. [His Honour did not regard] its construction as settled by existing authority". *Whitfords Beach* is interesting for the prospects it opens up; the case is a starting point for future development, rather than an answer to existing problems.

ELAINE WONG—Fourth Year Student.

[55] See R. W. Parsons, *Notes on the Law of Income Tax in Australia* (1981) Chapter II at 129-138.

[56] *Supra* n. 1 at 259.