THE RULE AGAINST ALIENATION OF PERSONAL EXERTION INCOME — DOES IT APPLY IN AUSTRALIA?

By

Allan Mason*

It is a fundamental rule of tax law that the owner of an income-producing source derives the income produced by it. Accordingly, if a taxpayer divests himself of that source or of the right to receive income from that source, he ceases to derive income from that source. The Commissioner of Taxation maintains, however, that income generated by a taxpayer's personal exertion is derived by that taxpayer notwithstanding the taxpayer's attempts to assign the source of that income to another. This proposition is commonly referred to as 'the personal exertion income rule' and has its origin in the English decisions of *Smyth* v. *Stretton*[1] and *Parkins* v. *Warwick*.[2] Though the rule has been applied by the New Zealand Supreme Court,[3] the Commissioner's success with its application in Australia is limited to decisions of the Boards of Review;[4] Australian courts have not, to date, applied the rule.

This article examines the validity of the personal exertion income rule and seeks to identify whether it applies to the more common income-splitting techniques. Those techniques usually comprise assignment by the taxpayer of either the income-producing source or the right to receive income from that source. The article will not address the potential application of the general anti-avoidance provisions contained in Part IVA (or its predecessor, s. 260) of the **Income Tax Assessment Act 1936 (Cth)**; the question of the rule's application is quite seperate and distinct from the question of whether Part IVA might apply to defeat an income assignment. Before implementing an income-splitting plan, however, the scope both of the rule and of Part IVA should be considered.

1. The Westminister Principle

Analysis of the personal exertion income rule must conform to the approach prescribed by the House of Lords in *Inland Revenue Commrs.* v. *Duke of Westminister.*[5] The essence of the *Westminister* doctrine is that, in taxation cases, it is improper for a court to disregard the legal rights and liabilities of parties arising pursuant to agreements made by them and to determine the parties' tax liability upon what the court perceives as the substance or effect of those arrangements. Thus, a court may not ignore the legal position in favour of the substance of the matter. Indeed, the substance of the matter is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles.[6] It will be recalled that in the *Westminister* case, their Lordships added that it was the right of every citizen to arrange his affairs so as to pay the least amount of tax possible,[7] though

---

*LL.M. (Qld.), Solicitor, Lecturer-in-Law, Faculty of Law, Queensland University of Technology.

1. (1904) 5 Tax Cas 36.
2. (1943) 25 Tax Cas 419.
3. *Spratt* v. *Commissioner of Inland Revenue (NZ)* [1964] NZLR 272; *Kelly* v. *Commissioner of Inland Revenue (NZ)* [1970] NZLR 161.
4. See, for example, 2 TBRD Case B 119 and 10 TBRD Case K 75.
5. [1936] AC 1.
6. *Ibid.* at 16 per Lord Tomlin.
7. *Ibid* at 8 and 19.

it should be added that that proposition is subject to any statutory provisions to the contrary, such as those contained in Part IVA and its predecessor s. 260.

Australian taxation law abounds with cases which have been resolved by application of principles developed in other areas of the law, particularly property law and equity[8] and, until recently, the authority of the *Westminister* decision in Australia was beyond question.[9] It has not, however, been without its critics.[10] Grbich explains the consequence of the principle's application thus:

> The taxpayer ... carefully selects the particular property rule to suit his job, as bricks in a tax avoidance structure. The selective proposition for which the case is 'authority' is taken out of context and used for a purpose it was never meant to serve by the judges who crafted the rules. The court in the tax case then refuses, on the authority of the *Westminster* doctrine, to consciously pass judgment on the fitness of the avoidance structure in terms of the objectives of the tax statute. It does not closely examine, in a case like *Brent*,[11] the full connotation (which can only be spelled out in context) of the property authority imported into tax. If the bricks and their juxtaposition satisfy the purely formal requirements of the narrow reading of a tax statute, that is enough.[12]

Criticism of the application of the *Westminster* approach is based largely on the view that it facilitated the large scale tax avoidance which existed in Australia in the 1970's. That a significant number of these tax avoidance schemes were contrived arrangements which achieved no purpose other than some taxation advantage for the participants could not be denied. But it also cannot be denied that Parliament had been alerted to the deficiencies of s.260, the general anti-avoidance provision of the Act, as early as 1957 when Kitto J. said in *F.C. of T.* v. *Newton*:

> Section 260 is a difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the time to analyse his ideas and define his intentions with precision before putting pen to paper.[13]

It was not until 1981, however, that Part IVA was enacted to replace the section. Kitto J's comments appear to have been heeded by the draftsman of that Part and the success of the Part in eliminating the blatant tax schemes reflects the careful drafting of the provisions. Part IVA evidences that it is possible for Parliament to enact an effective general anti-avoidance provision provided it is carefully drafted. Section 260 was not such a provision.

The proliferation of tax avoidance in Australia was not the result of the action of the courts in adopting the *Westminster* doctrine in taxation cases. Rather, it was the result of the inaction of the Parliament in failing to legislate to prevent such avoidance.

> The function of the court is to interpret and apply the language in which the Parliament has specified (the circumstances which will attract an obligation on the part of the citizen to pay tax). The court is to do so by determining the meaning

---

8. See, for example, *Norman* v. *F.C. of T.* (1963) 109 CLR 9; *Shepherd* v. *F.C. of T.* (1965) 113 CLR 385; *F.C. of T.* v. *Everett* (1980) 143 CLR 440.
9. See, for example, *Mullens & Ors* v. *F.C. of T.* (1976) 135 CLR 290 at 298 per Barwick C.J.; *The Federal Coke Company Pty. Ltd.* v. *F.C. of T.* (1977) 77 ATC 4255 at 4263 per Bowen C.J.; *F.C. of T.* v. *Westraders Pty. Ltd.* (1980) 144 CLR 55 at 60 — 61.
10. R.W. Parsons *Income Taxation in Australia* Law Book Company 1985 at 138 para.2.421; Y. Grbich 'The Duke of Westminister's Graven Idol on Extending Property Authorities into Tax and Back Again' (1978) 9 FLRev 185; R.E. Krever 'Furniss v. Dawson — Tax Jurisprudence Re-enters the Real World' (1983-84) 18 Taxn. in Aust. 1057.
11. *Brent* v. *F.C. of T.* (1971) 125 CLR 418.
12. Grbich, (1978) 9 FLRev 185 at 209.
13. (1957) 96 CLR 577 at 596.

> of the words employed by the Parliament according to the intention of the Parliament which is discoverable from the language used by the Parliament. It is not for the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.[14]

In the United Kingdom, the absence of general anti-avoidance provisions in that country's capital gains tax legislation has resulted in recent years in the House of Lords placing significant qualifications upon the *Westminster* doctrine's application. *W.T. Ramsay Ltd* v. *Inland Revenue Commrs.*,[15] *Inland Revenue Commrs.* v *Burmah Oil Co.*[16] and *Furniss* v. *Dawson*[17] concerned the efficacy of certain schemes designed to avoid or defer liability to capital gains tax and the decisions turned upon the application of the statute to the facts. In each case, the Court found for the Revenue and in so doing formulated the doctrine of fiscal nullity. Lord Brightman prescribed the following conditions for the doctrine's application:

1. there must be a pre-ordained series of transactions or a single composite transaction which may or may not include the achievement of a legitimate business objective; and
2. there must be steps inserted which have no business purpose apart from the avoidance of tax.

If these circumstances exist, the inserted steps are disregarded for fiscal purposes and the court looks at the end result, the taxation of which depends on the terms of the taxing statute under consideration.[18]

These decisions have been the subject of much criticism in Australia, being described by one commentator as 'one of the most extraordinary assumptions of judicial power as against the legislature that has taken place during this century.'[19] The Full Federal Court in *Oakey Abattoir Pty Ltd* v. *F.C. of T.*[20] rejected the doctrine's application in Australia, relying upon the observations of Gibbs J., as he then was, in *F.C. of T.* v. *Patcorp Investments Limited*[21] that the presence of s. 260 rendered it impossible to place qualifications upon other provisions of the Act in order to prevent tax avoidance.[22] The Federal Court in *Oakey Abattoir* described the doctrine of fiscal nullity as rules governing the statutory interpretation of the United Kingdom capital gains tax legislation.[23] At this time therefore, the doctrine does not apply in Australia though the Commissioner has stated that he will continue to argue its application before the courts in order to reserve his rights to do so before the High Court in an appropriate case.

The doctrine of fiscal nullity represents the response of the House of Lords to the problem of preventing tax avoidance in the absence of an effective general anti-avoidance provision.

---

14. *F.C. of T.* v. *Westraders Pty Ltd* (1980) 144 CLR 55 at 59 — 60 per Barwick C.J. Compare these comments with those of Murphy J in that case at 79 — 80. Refer also to the judgment of Deane J in *F.C. of T.* v. *Westraders Pty Ltd* (1979) 79 ATC 4089 at 4098 (Fed. Ct).
15. [1982] AC 300.
16. [1982] STC 30 HL.
17. [1984] 2 WLR 226.
18. *Ibid* at 242.
19. I.C.F. Spry 'Fiscal Nullity in Australia' (1984) 13 ATRev 150 at 153; see also I.V. Gzell 'Doctrine of Fiscal Nullity and its Application in the Australian Context' a paper presented at the State Convention of the Victorian Division of the Taxation Institute of Australia, October 1984; D. Russell 'Bury the Great Duke' (1984-85) 119 Taxn. in Aust. 250. cf. R.E. Krever *supra* n. 10.
20. (1984) 84 ATC 4718.
21. (1976) 140 CLR 247.
22. *Ibid* at 292.
23. *Supra* n. 20. at 4725 — 4726.

No doubt it will be many years before the operation and limitations of that doctrine are defined by the courts, a fact which inevitably will lead to uncertainty in the community as to whether particular transactions or arrangements fall within its ambit. In Australia, on the other hand, the presence of Part IVA in the Act renders it unnecessary and undesirable to apply the doctrine. Though the provisions of that Part have yet to be considered by the courts, there is a considerable body of jurisprudence in relation to its predecessor, s. 260, which is undoubtedly relevant to the interpretation of the Part.[24] And, unlike the doctrine of fiscal nullity and s.260, the consequences of the application of Part IVA are detailed in the Part.[25]

It is essential that, as far as possible, there is certainty in the law and the interests of certainty are best served by the Commissioner's reliance upon the anti-avoidance provisions of the Act in appropriate cases.[26]

Thus, the approach presently required to be taken by courts in the resolution of taxation cases is, firstly, to determine the efficacy at law or in equity of the transactions entered into by the taxpayer by the application of general law principles and, secondly, to consider the effect upon those transactions of any anti-avoidance provisions of the Act.

2. Origins of the Personal Exertion Income Rule

It is therefore clear that the efficacy of an assignment of personal exertion income ought to be determined by reference to appropriate principles of law or equity[27]. A brief analysis of the court decisions in which the application of the rule has been argued, however, reveals a departure from that approach. It is not surprising, therefore, that the personal exertion income rule should have been the subject of much academic criticism.[28]

That the rule is of questionable validity was expressed by the High Court in *F.C. of T.* v. *Everett*,[29] the majority of the Court[30] commenting that the Commissioner was unsuccessful in identifying its origins or its precise area of operation.[31] The Court further commented:

> One thing at least is clear, and that is that the principle is one of taxation law, not of equity. Even an equitable assignment for value of future property gives the assignee a right to the subject matter as soon as it comes into existence.[32]

So too, in his dissenting judgement in *Everett's* case in the Federal Court, Deane J. said:

> I would note that my conclusion in that regard does not involve necessary acceptance of the broad statements which are found in some judgments to the effect that it is impossible, for income tax purposes, effectively to assign the whole or part of what are in truth earnings from personal activities.[33]

The origins of the rule can be traced to *Smyth* v. *Stretton*,[34] though that case did not

---

24. See, for example, R. Bainton 'The Relevance of Decisions upon Section 260 in the Construction of Part IVA of the Income Tax Assessment Act' (1981) 11 QLSJ 281; T. Boucher 'Section 260/Part IVA — the Doctor's Cases' (1985-86) 20 Taxn. in Aust. 633.
25. Section 177F.
26. See also I.L.M. Richardson 'Appellate Court Responsibilities and Tax Avoidance' (1986) 2 *Australian Tax Forum* 3 at 20.
27. Of course, the *Westminster* doctrine has no application where the provisions of s. 260 or Part IVA of the Act are in issue.
28. See B. Marks *Alienation of Income* 2nd edn., Sydney: C.C.H. 1982 Chapter 7; L. McKay 'The Arcus and Personal Service Income Principles' (1974) 6 NZULRev 140; J. Campbell 'Alienation of Income from Personal Services' (1986-87) 21 Taxn. in Aust. 11; P.J. Norman 'The Alienation and Diversion of Personal Exertion Income' (1986) 15 ATRev 208.
29. (1980) 143 CLR 440.
30. Barwick C.J., Stephen, Mason and Wilson JJ., Murphy J. dissenting.
31. *Supra* n. 29. at 453.
32. *Ibid.* at 453.
33. *F.C. of T.* v. *Everett* (1978) 78 ATC 4595 at 4612.
34. (1904) 5 Tax Cas 36.

involve any attempt by the taxpayer to alienate or assign his income. In issue was the taxpayer's liability to pay income tax upon amounts paid by his employer, the Governors of Dulwich College, to the credit of a provident fund. The terms of the provident scheme were, inter alia, that certain 'increases in salaries' were to be granted to Assistant Masters having not less than five years service. These increases, in two amounts of five per cent each, were not payable in cash to the employees, but were credited to the provident fund. Entitlement of an Assistant Master to one of these amounts together with interest thereon arose upon cessation of employment for any reason other than ill health. Entitlement to the second amount and accumulated interest was contingent upon the exercise by the Governors of their discretion to pay the same where the Assistant Master's retirement was caused by ill health.

Notwithstanding that the taxpayer did not obtain present enjoyment of these monies and might never have done so, the Court held that the increases in salaries were income of the taxpayer falling within Schedule E of the **Income Tax Acts** (U.K.) being emoluments accruing by reason of an office or employment. Channel J. treated the case as one in which the taxpayer first derived income amounts which were subsequently applied for his benefit. In so far as the taxpayer's entitlement to payment from the provident fund was contingent upon the happening of certain events, His Honour likened the arrangement to the payment by the taxpayer of premiums on an insurance policy which entitled him to the payment of monies in certain circumstances. Although the employer in fact paid the 'premiums', those payments were made with salary increases to which the employees were entitled. During the course of the judgement, His Honour said that it was established:

> that a sum receivable by way of salary of wages is not the less salary or wages taxable because for some reason or other the person who receives it has not got the full right to apply it just as he likes. The fact that income which is income, but which has even by operation of some statute to be devoted compulsority to some purpose or another, does not prevent it being income.[35]

As a statement of principle that a taxpayer will derive income notwithstanding that it is not received by him but is applied to his benefit, the above statement is beyond doubt; that is precisely the circumstance in which s.19 of the Act operates to deem the taxpayer to have derived the income. A purported alienation of the right to receive the income is an entirely different matter, however, and raises the question whether the taxpayer ceases to derive the income at all.

The later case of *Parkins* v. *Warwick* [36]is more to the point as it concerned the tax effects of the assignment of the taxpayer's right to receive certain payments. Pursuant to an agreement made between the taxpayer and Central Underwriters Syndicate Ltd., the taxpayer agreed to charge Bramansu Gold Corporation Ltd., a company of which he was the managing director, not more than 100 pounds per annum (the fee payable to him as Chairman of that company). For its part, Central Underwriters agreed to pay the taxpayer certain monies. The taxpayer subsequently assigned to a creditor' all his right title and interest and benefit in the agreement. Assuming that the right to the payment of these monies by Central Underwriters was presently existing and that the payments in the taxpayer's hands would be income, the assignment was a classic alienation of income; it was not a case of the application of income already derived by the taxpayer. Unfortunately, the taxpayer conceded the income point i.e. that the payments represented emoluments of his office.

Macnaghten J. held that the payments were first received by the taxpayer as emoluments

35. *Ibid.* at 42.
36. (1943) 25 Tax Cas 419.

and then paid to the assignee (then lent back to the taxpayer). In referring to the above passage in *Smyth* v. *Stretton*, His Honour said:

> It did not, I think, occur to Channell J. that it would be possible for anyone to argue that where the recipient of an emolument had got the full right to apply it just as he liked, he could by any assignment release himself from the obligation to pay Income Tax on it. In the present case Mr. Parkins was free to deal with these emoluments as he pleased. He could, and he did, make them over to Mr. Pietersen. But the fact that he did so does not render the emoluments any the less assessable to Income Tax.[37]

Even with the taxpayer's concession that the payments were emoluments of his office, it was open to the court to hold that the right to them, if it was present property, was validly assigned to the assignee and that the income had been alienated. Yet there is no discussion of the technicalities of property law to which we in Australia are accustomed. Rather, the court either ignored the assignment or treated it as ineffective; it approached the case as one of the application of income first derived by the assignor.

Be that as it may, the Australian Boards of Review and the New Zealand courts embraced these cases and elevated them to the status of authority for the proposition that:

> There is hardly any type of receipt which is more clearly income to the recipient (and to no one else) than the wages he receives from his employer under a contract of emplyment. To our minds, there is no question that this is his income, assessable to him for income tax. He may, of course, do what he likes with his income, but that will not affect his liability for income tax. He may, if he wishes, hand his wages or portion of them, over to his wife in recognition of the sterling services she performs in the home, or he may, in a case such as this agree to have them brought into account for the purposes of determining how the income that he does derive in partnership with his wife shall be distributed. But, in our opinion, there is nothing he can do to make his own wages income of the partnership in such a way as to relieve himself of assessment upon them as such.[38]

Subsequently, the principle was extended to cover not only income from employment but all income from personal exertion.[39]

In the New Zealand decisions of *Spratt* v. *Commr. of Inland Revenue (NZ)*[40] and *Kelly* v. *Commr. of Inland Revenue (NZ)*[41] the courts, in obiter, accepted the rule but did not attempt to identify its origins.

The extent of the rule was put in these terms by the majority of the High Court in *Everett's Case*:

> In some instances, as in *Parkin's Case* and *Spratt's Case*, the suggestion seems to be that salary and wages so obviously constitute income of the person to whom they are payable that they do not cease to be income in his hands because they have been assigned to another. An allied suggestion is that an assignment of future income from personal exertion is ineffective to deprive the income of its character as assessable income in the hands of the person who earns it. Another suggestion is that the principle is not confined to assignments of future income and that it extends to present assignments of a proprietary right carrying a right to future income if that future income derives from personal exertion, namely partnership profits. Each of these

37. *Ibid.* at 424.
38. 2 TBRD Case B 119 at 608.
39. 10 TBRD Case K 75.
40. [1964] NZLR 272.
41. [1970] NZLR 161.

suggestions gives the principle an application which takes it further than sec. 19 of the Act.[42]

3. The Personal Exertion Income Rule and Assignments of an Income-Producing Source

Having established that no decision to date is authority for the proposition for which the rule stands, it is necessary to determine, having regard to the *Westminister* principle, whether the rule does have some foundation in law or equity. We shall firstly examine the application of the rule to the assignment by a taxpayer of the legal source of the income.

It is clear that the personal exertion income rule has no application to assignments of income-producing property such as real estate or shares. In such cases, the income is generated by the property itself with little, if any, activity required on the part of the owner. Upon assignment of the property, the assignee derives the income subsequently generated, the right to that income being one of the rights of ownership acquired as a result of the assignment.

Unfortunately, it is not always a simple matter to identify property as the source of income. Consider the case of income generated by the carrying on of business. Business income might be seen as flowing substantially from either the exertions of the proprietor or the goodwill and other assets of the business. Some businesses are capital intensive; others employ little, if any, capital. It is possible to carry on business as a share trader, for example, armed only with a newspaper and phone. On the other hand, a share trading business might employ many skilled staff and sophisticated equipment.

In many circumstances, it will be possible to identify the source of business income as property viz. the goodwill and other assets employed in its operation. Large manufacturing and retail concerns are obvious examples. These are cases in which the income is substantially generated by those assets rather than by the personal exertions of the proprietors. The identification of the source of income is more difficult when it may be seen as generated by a combination of the property employed in the business and the proprietor's exertions. Fortunately, there is authority on point.

(a) Partnership Income

Where a taxpayer derives income from a partnership, *Everett's Case* stands as authority for the proposition that his income is generated by property only. The case concerned the efficacy of the assignment by the taxpayer to his wife of 6/13ths of his share in a partnership of solicitors together with all rights to which the assignee became entitled pursuant to sec.31 of the **Partnership Act** (N.S.W.). The application of s. 260 of the Act was not in issue and the decision rests therefore upon the application of general law principles to the facts in accordance with the *Westminster* doctrine. The Commissioner's principal contention was that the taxpayer's income was income from personal exertion and therefore future property — a mere expectancy; the personal exertion income rule applied. This contention had found favour with Deane J. when the case was before the Full Federal Court, though His Honour was in the minority. Deane J. identified the source of the taxpayer's income as personal exertion:

> The income of the partnership consisted of fees paid for professional work performed by themselves or, under their supervision, by those whom they employed in carrying on the partnership business. Neither the income nor the profits of the partnership business could, in my view, properly be seen, in so far as the partners were concerned,

42. *Supra* n. 29 at 453.

> as being derived either from the partnership assets used in the business or, in any relevant sense, from the activities of the staff employed by the partners in the course of their carrying on the partnership business. The income and profits of the partnership were derived by the partners from their activities (including use of partnership assets and the employment of partnership staff) in the carrying on of the partnership business and were the fruits of the personal exertion of the four partners.[43]

Later in his judgment, His Honour said that, as a matter of substance and reality, the partnership profits resulted from the partners' exertions.[44] Thus, His Honour was identifying the practical, rather than the legal, source of the taxpayer's income.

On appeal, the High Court by majority identified the legal source of the taxpayer's income as property, a chose in action assignable in whole or in part. Once this conclusion was reached and the assignment held to have been valid, the Court held that the income generated by the property assigned was assessable income of the assignee, albeit as a result of s. 97 of the Act. In reaching this conclusion, the Court was influenced by earlier authority concerning the nature of the interest of a partner in a partnership[45] rather than by the size of the practice or the nature of the activities of the partners. There is no reason to suspect, therefore, that the decision in *Everett* would have been different had the firm concerned been larger or smaller and in no case decided subsequently concerning similar assignments has the Commissioner sought to distinguish *Everett* on that ground. Note, however, that the practical source of a partner's income is a relevant consideration in the context of the application of Part IVA.

Accordingly, it can be said that the personal exertion income rule has no application to an equitable assignment by a partner of a share in a partnership.

(b) Income of Sole Traders and Sole Practitioners

Where a taxpayer's income is generated by a combination of the proprietor's personal exertion and business assets, the most common technique adopted to facilitate income-splitting is the assignment of the business assets to a company controlled by the taxpayer. That company is usually trustee of a trust created for the benefit of the taxpayer and his family. The trustee then employs the taxpayer to perform the same functions and duties carried on by him before the assignment. Is the legal source of that income property which has been assigned to the assignee?

There is evidence to suggest that the courts will not engage in any type of apportionment of the source but rather will treat the income as legally sourced in property viz. the business assets. Thus, as Bowen C.J. said in *Everett's Case*[46] when that case was before the Federal Court:

> Where there is a trust in respect of assets of a business but the income produced flows not simply from those assets but also significantly from the efforts of partners including the trustee, the case is more difficult. Such cases cover a wide range. It may be a grazing business where sheep also play a significant part by producing wool. It may be a pharmacy where turnover of stock and the provision of professional

---

43. *F.C. of T.* v. *Everett* (1978) 78 ATC 4595 at 4605.
44. *Ibid.* at 4605.
45. *Canny Gabriel Castle Jackson Advertising Pty Ltd & Anor.* v. *Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321; *Livingstone* v. *Commr. of Stamp Duties* (Qld) (1960) 107 CLR 411; *Hocking & Ors* v. *Western Australian Bank* (1909) 9 CLR 738.
46. *Supra* n. 43.

> services both contribute. It may be a legal practice where the firm name and goodwill (including wills in the strongroom) contribute significantly to income and where the premises, library, furniture and office equipment as well as the efforts of employees also contribute but where the provision of professional services by the partners is the most significant factor ...Where there is a trust in respect of a partnership share in such a business, it appears to me that the beneficial interest in the income referable to that partnership share falls to be taxed under Div. 6 . . . It would hardly be possible to disentangle what part of the income of the business was attributable to different factors, say, to goodwill or to the personal effort of partners. And it would be wrong, in my opinion, to attempt to introduce into Div. 6 notions of 'income from property' and 'income from personal exertion' at one time important in the Assessment Act for the purpose of determining differential rates of tax.[47]

Although His Honour was dealing with a trust of what was subsequently held by the High Court to be property, viz. a chose in action constituted by a partner's share in the partnership, his comments do indicate a reluctance to apportion the source of income between personal exertion and property.

In *Gulland* v. *F.C. of T.*,[48] Kennedy J. of the Supreme Court of Western Australia held that the income of a medical practice was income of a trust estate despite the fact that it was primarily generated by the personal exertions of the taxpayer who had previously carried on the practice on his own account. His Honour's conclusion was based upon the fact that the taxpayer was an employee of the trustee and it was the trustee, not the taxpayer, who was carrying on the business.[49] In support of this view, His Honour cited *F.C. of T.* v. *Phillips*.[50] The basis of His Honour's decision in *Gulland's Case* is that the taxpayer divested himself of the goodwill, plant, equipment and other assets of the business and thereafter performed services not as principal but as an employee. The trustees as owners of the practice entered into contracts with the patients and derived the income generated in carrying on the practice. Kennedy J. reached a similar conclusion in *Watson* v. *F.C. of T.*.[51]

Further support for the validity for income tax purposes (apart from the operation of s. 260 or Part IVA) of similar arrangements designed to split the income of independent contractors may be found in the Full Federal Court's decision in *Tupicoff* v. *F.C. of T.*[52] That case concerned an insurance agent who adopted an income-splitting scheme which had become popular among insurance agents and independant consultants. From 1970 until 1978, the taxpayer was agent for an insurance company. In June 1978, he tendered his resignation whereupon the insurer forthwith appointed as its agent in his stead a company of which he and his wife were directors. Of the two issued shares in the company, one was held by the taxpayer and his wife jointly and the other by the insurer. The company was trustee of a discretionary trust established for the benefit of the taxpayer and his family. The evidence revealed that the taxpayer had employed few fixed assets in the business and it was apparently unlikely that there was any goodwill attached to the business, the agency contract with the insurer being expressed to be personal to the taxpayer and incapable of assignment. After these arrangements were implemented, the taxpayer continued selling insurance as he had previously done.

---

47. *Ibid.* at 4599. See also the discussion of this topic by T.W. Magney and P.C. Green, 'Thoughts related to Everett's case: With Particular Reference to the Sole Practitioner' (1978-79) 13 Taxn. in Aust. 762.
48. (1983) 83 ATC 4352.
49. *Ibid.* at 4368.
50. (1978) 78 ATC 4361.
51. (1983) 83 ATC 4336 at 4349.
52. (1984) 84 ATC 4851.

Although the Commissioner was successful in arguing that s. 260 applied to render the arrangements void for tax purposes, he was unsuccessfull in his attempt to have the Court apply the personal exertion income rule. The Federal Court rejected the argument, identifying the legal source of the income as property viz. the agency contract, a chose in action.

Beaumont J. with whom Fisher and Jenkinson JJ. agreed said:

> The statements in *Spratt* and *Peate*, supra, may, I think, be distinguished for present purposes. These cases may well have been in point here if, say, the company in this case had purported to assign to a third party its remuneration under its contract with NML. But no such question arises here. In my opinion, once it is accepted that no 'sham' is involved, it must follow that the legal source of the company's income is its contract of agency with NML. It further follows that no question of any attempt to assign any income can arise in the present case: on the hypothesis that there is no 'sham', and this hypothesis must now be accepted, the efforts of the taxpayer should be seen as acts done by the company, through the taxpayer as its agent for the purpose, in the performance of its agreement with NML. From it inception, the commission was income technically derived by the company. Since, apart from the possible operation of sec. 260, it never was the taxpayer's income to assign, no question of his purporting to assign it can arise.[53]

Both Fisher and Beaumont JJ. rejected the contention that the practical source of the income — the personal exertions of the taxpayer — or the reality or substance of the matter were relevant considerations when determining who derived the income. Beaumont J. expressly drew a distinction between, on the one hand, the legal source of the income and, on the other, its practical source, the latter being relevant in the context of the application of s.260,[54] the former in the context of the application of the general law to the facts. The same distinction is at least implicit in the judgment of Fisher J. when he acknowledged that, as a matter of law, the taxpayer was employed by the trustee which held the agency from the insurer.[55]

There is ample authority that companies and trustees may contract to render services and employ persons to perform them[56] and in none of the recent cases in point has the Commissioner challenged the validity of the arrangements on general law principles. So too, it is clear from the foregoing that although business income may be generated by a combination of personal exertion and property or by personal exertion only, it is nevertheless possible for the taxpayer to divest himself of that income by ceasing to conduct the business on his own account whereupon an entity controlled by the taxpayer conducts that business. Apart from the application of anti-avoidance provisions, these arrangements will be effective to vest in the assignee property which is the legal source of income formerly derived by the taxpayer; it is irrelevant that the taxpayer continues to perform as an employee personal services which he had previously performed as principal. In such circumstances, the personal exertion income rule will have no application.

(c) Income of Wage and Salary Earners

Schemes of the type considered in *Tupicoff's Case* were utilized by large numbers of wage and salary earners also, particularly professional employees such as architects and engineers.

---

53. *Ibid.* at 4861.
54. *Ibid.* at 4863.
55. *Ibid.* at 4853.
56. *F.C. of T.* v. *Mitchum* (1965) 113 CLR 401; *F.C. of T.* v. *Phillips* (1978) 78 ATC 4361; *Tupicoff* v. *F.C. of T.* (1984) 84 ATC 4851; *F.C. of T.* v. *Gulland; Watson* v. *F.C. of T.; Pincus* v. *F.C. of T.* (1985) 160 CLR 55.

Although it can be said of employees that the practical source of their income is the rendering of personal services by them, the decision in *Tupicoff* makes it clear that the courts will have regard to the form of the transaction and identify the legal source of the income as the contract of employment. There is no reason to believe that, apart from the application of anti-avoidance provisions, employees who entered into those schemes would not have been successful, on general principles, in shifting derivation of income to the new contractor.

(d) **Conclusion**

From the foregoing, it would appear that the personal exertion income rule has no application in Australia where a taxpayer seeks to shift the derivation of income to another by divesting himself of the legal source of that income. Attempts to alienate that income, however, present a number of problems.

4. The Personal Exertion Income Rule and the Alienation of Income

There is no doubt that, in Australia, it is possible for a taxpayer to assign to another the right to receive future income from property owned by the taxpayer with the consequence that the income is subsequently derived by the assignee notwithstanding that the assignor remains owner of the underlying property.[57] Indeed, the presence of Division 6A of Part III in the Act implicitly recognizes the fact. The efficacy of such alienations is based on the proposition that the right to future income from property may itself be a proprietary right — a chose in action — capable of present assignment; the owner for the time being of that right derives the income attributable to it. However, the cases which have concerned attempts to alienate income have highlighted a number of problems with the technique, the principal difficulty being the uncertainty as to whether there exists a present right to income to be generated by the property in the future.[58]

The resolution of this problem is difficult enough where income has its practical source in property only such as real estate, shares or debentures, though excellent guidance may be obtained from McKay's scholarly article on point.[59] Where, however, income has its practical source in either a combination of property and personal exertion or personal exertion only, the only judicial guidance on the efficacy of attempts to alienate such income is provided by obiter comments in some of the leading cases on income splitting. Most of these comments were addressing the validity of the Commissioner's argument that, for taxation purposes at least, income from personal exertion may not be assigned so that it ceases to be derived by the assignor.

In nearly every case, personal exertion income will have its legal source in contract. In the case of an employee deriving salary or wages, the legal source of that income is the employment contract whereas in the case of sole traders and professional persons, the contract with the customer or client is the legal source of the income.[60] The object of alienation of this income is for the taxpayer to divest himself of the right to receive income which he may earn in the future and to vest that right in another; an assignment of that right is executed by the taxpayer in favour of the assignee.

Although a contract between a taxpayer and his employer, customer or client is one of personal service and is therefore incapable of assignment,[61] there is authority for the

---

57. *Shepherd* v. *F.C. of T.* (1965) 113 CLR 385; *Booth* v. *F.C. of T.* (1987) 87 ATC 5100; See also B. Marks, *Alienation of Income* 2nd edn., Sydney: C.C.H. 1983; King, J.C. 'Alienation of Income (1979-80) 14 Taxn. in Aust. 354 at 413.
58. *Norman* v. *F.C. of T.* (1963) 109 CLR 9; *Shepherd* v. *F.C. of T.* (1965) 113 CLR 385.
59. L. McKay 'Some Aspects of the Alienation of Income for Taxation Purposes' (1974) 6 NZULRev 1.
60. *Tupicoff's Case supra* n.52. at 4861.
61. *Chitty on Contracts* 25th ed. Sweet and Maxwell 1983 at 712-713; K.E. Lindgren, J.W. Carter and D.J. Harland, *Contract Law in Australia* Butterworths 1986 at 311.

proposition that the remuneration payable pursuant to such contracts, as opposed to all the taxpayer's rights and obligations pursuant thereto, is capable of assignment[62]. (It should be noted, however, that such assignments may be void as contrary to public policy[63] if, for example, their effect is to deprive the assignor of the means of his livelihood).[64]

(a) **Present Chose or Expectancy?**

Is the right to renumeration for personal services a present right to income to be derived in future or only an expectancy or possibility that such right will arise in future? It seems that the better view is that the right to future income from personal exertion is an expectancy. In general, an employee's right to remuneration from his employer is dependant upon the performance of his duties as employee. Contracts of employment are usually construed as entire contracts.[65] So too in the case of a solicitor, for example, the right to recover fees arises in general only upon completion of the services he contracts to perform.[66] In neither case could it be reasonably argued by the taxpayer that there existed a present right to be paid income in the future; that right is contingent upon the performance of the relevant services. This view is supported by obiter comments of the majority of the High Court in *Everett*:

> (The personal exertion income rule) has been usually employed to signify income by way of wages or salary under a contract of employment where the contractual right to receive the income has been incapable of present assignment. It would also apply to the income earned by a sole trader who operates a business and a professional man who practices on his own account. In this context it is correct to say that the taxpayer's remuneration is the product of his personal exertion and all that he has to assign are his future receipts as distinct from any right to receive those receipts.[67]

However, McKay suggests that in determining whether a right to remuneration which is based upon a contract is a present chose or an expectancy, the possibility that the remuneration may not become payable in the event that one party breaches the agreement is not a relevant consideration.[68] He finds support for this proposition in *Shepherd*[69] where the High Court held that the taxpayer's right to future royalties was a present chose in action notwithstanding that no royalties might become payable at all, the licencee of the taxpayer's patent being under no obligation to exploit the patent rights. McKay explains the decision as follows:

> Clearly one may possess a right to payment which continues to exist despite the fact that no payment may be made. In *Shepherd* v. *F.C. of T.* this point is explicitly made. 'That a promise may not be fruitful does not make it incapable of assignment.' per Barwick C.J.[70]

The majority of the cases dealt with by McKay in his article concerned the assignment of property income and it may be thought that the above proposition has no application

---

62. G.H.L. Fridman *The Modern Law of Employment* Sweet & Maxwell 1963 at 49; B. Marks *Alienation of Income* 2nd edn. Sydney; C.C.H. at 323-324; *Jones* v. *Humphreys* [1902] 1 KB 10; *Crouch* v. *Martin & Ors* 23 ER 987; *Tom Shaw & Co.* v. *Moss Empires Ltd and Bastow* (1908) 25 TLR 414; *Horwood* v. *Millars Timber and Trading Company Limited* [1917] 1 KB 305; *Field* v. *Battye* (1939) SASR 235
63. B. Marks, *Alienation of Income* 2nd edn. Sydney: C.C.H. 1982 at 347-348.
64. *Horwood* v. *Millar Timber and Trading Company Limited* [1917] 1 KB 305.
65. J.J. Macken, C.J. McCarry and C. Sappideen *The Law of Employment* 2nd edn. Law Book Company 1984 at 148 — 151.
66. In *re Romer & Haslam* [1893] 2 QB 286 at 293 and 298.
67. *Supra* n. 29. at 454.
68. McKay 'Some Aspects of the Alienation of Income for Taxation Purposes' (1974) 6 NZULRev 1 at 18-19.
69. *Shepherd* v. *F.C. of T.* (1965) 113 CLR 385.
70. *Supra* n. 68 at 18 and 19.

to the case of alienation of personal exertion income; in the case of the former class of income, no activity is required on the part of the assignor to generate the income whereas, of course, the converse is true of the latter class. However, McKay also finds support for the proposition in *Hughes* v. *Pump House Hotel Company Limited.*[71] In that case, the English Court of Appeal appears to have assumed that the assignment by a builder of all moneys due or to become due to him from the defendant pursuant to a building contract between them was an effective legal assignment of a present chose. The Court ignored the possibility that no moneys may become payable under the contract if, for example, the builder failed to perform his contract. The assignment apparently was not of the right to future payments but of the future payments themselves. Nevertheless, the judgments contain no discussion of that distinction nor do they consider the question whether that which was assigned was *debitum in praesenti solvendum in futuro* or an expectancy. The Court held, that the assignment was an absolute assignment within the meaning of sec. 25(6) of the **Judicature Act** 1873 and it appears that that point was the only issue to be determined and upon which argument was addressed to the Court. Indeed, the question arose in an action by the builder against the defendant for moneys owing upon completion of the work. The defendant argued that the builder could not bring proceedings in his name having executed a legal assignment of the moneys to his bank. The Court of Appeal agreed. This case was cited with approval by Kitto J. in *Shepherd's Case* in the context of consideration of the effect upon the assignment there in question of the possibility that no money may become payable by the licencee to the taxpayer.

It is difficult to reconcile the decision in *Hughes* with some later cases. For example, in *Horwood* v. *Millars Timber and Trading Company Limited,*[72] Warrington L.J. held that the future wages and salary there in question were undoubtedly expectancies incapable of present assignment at law. So too it is clear from *Shepherd's Case* that although the right to future royalties there in question was held to be present property, the future royalties themselves were expectancies. It may be reconciled only by assuming that the Court of Appeal in *Hughes'Case* considered that the assignment was of the builder's right to future payments and that this right was a present chose in action capable of assignment at law. The case was not a tax case however and, though it lends some support to the proposition that the right to future income from personal exertion is a present chose, there is at least one strong reason for rejecting that proposition.

In *Shepard's Case,* Kitto J. reconciled his decision in that case with the High Court's decision in *Norman*[73] by reference to the contracts between the taxpayers and the third parties. He pointed out that the contract of loan in question in *Norman* left the borrower to decide whether a relationship would exist at all whereas the licence in *Shepherd* would continue throughout the period of the assignment. It was in this context that His Honour cited *Hughes.* In *Hughes* a contractual relationship existed between the builder and the defendant and the Court appears to have been prepared to assume that the builder's right to remuneration in future payable pursuant to that contract was a present right capable of legal assignment. Applying this approach to the case of a wage or salary earner, it is clear that, although there is an employment contract between employer and employee, it is usually the case that either party may terminate that contract on reasonable notice.[74] On the other hand, sole traders, sole practitioners and independant contractors usually have a number of customers

71. [1902] 2 KB 190.
72. [1917] 1 KB 305 at 315.
73. *Norman* v. *F.C. of T.* (1963) 109 CLR 9.
74. Macken, Chapter 5.

or clients with whom they contract from time to time so that future income will be sourced partially in existing contracts and partially in contracts to be entered into in future. Thus, except perhaps in the case of fixed term employment contracts and existing contracts for the execution of work or the performance of services made between the taxpayer and his customer or client, it seems clear that there is no presently existing right to future income from personal services rendered by an individual and this view finds strong support from obiter comments in *Everett's Case.* There can only be an expectancy of future wages. There can only be an expectancy of a future receipt in respect of services or goods supplied by a taxpayer engaged in business.[75]

Assignment of the future right to income from personal exertion is therefore more likely than not an expectancy, in general. In equity, such assignments supported by valuable consideration would be treated as contracts to assign the right when that right comes into existence i.e. when the assignor completes the services which entitle him to remuneration.[76]

In these circumstances, the success of the alienation of the income will depend upon whether, at the point in time when the chose in action viz. the right to the personal exertion income, comes into existence, the assignor first acquires both the legal and beneficial title thereto, albeit instantaneously before beneficial title passes to the assignee. If this be so, then the income payable at that time is income derived by the assignor which has been applied by him for the benefit of the assignee. If, on the other hand, beneficial title never vests in the assignor but vests immediately in the assignee, the taxpayer may argue that he was not at any time beneficially entitled to that chose in action but held the same on trust for the assignee who will derive the income flowing from ownership of that chose.

Unfortunately, the question is undecided, although the consequences of the intervention of equity in these circumstances have been explained in terms which suggest that the better view is that the assignor never acquires beneficial title to the property; it vests immediately in the assignee. In the leading case of *Holroyd* v. *Marshall,*[77] Lord Westbury L.C. stated that the beneficial interest in the expectancy assigned passes to the assignee immediately the property is acquired by the assignor.[78] Later cases have established that the assignee's rights do not rest solely upon the contract to assign since the assignment of the property operates automatically the property is acquired by the assignor without further action on the assignor's part.[79] When *Everett's Case* was before the Full Federal Court, Deane J. (dissenting) said:

> Even pending acquisition by the intending assignor, the intended assignee enjoys more than the traditional concept of an equitable right *in personam* against the assignor. The relevant equitable principle does not depend upon the possibility of a court of equity decreeing specific performance with the consequence that the assignee's beneficial interest could not arise until after acquisition by the assignor. The relevant principle is that equity considers as done that which ought to be done. The consequence is that the beneficial interest in the property the subject of the assignment never vests in the assignor when the property is acquired by him. He holds it immediately in trust for the assignee.[80]

---

75. R.W. Parsons *Income Taxation in Australia, Law Book Company 1985 at 774 para. 13.44.*
76. *R.P. Meagher, W.M.C. Gummow and J.R.F. Lehane Equity — Doctrines and Remedies* 2nd edn. Butterworths 1984 at 170 para. 638.
77. 11 E.R. 999.
78. *Ibid.* at 1007.
79. Meagher, 177-183, particularly at 181-182.
80. *Supra* n. 43 at 4609.

Though the cases cited by His Honour do not expressly support the conclusion reached by him, that conclusion is, with respect, a logical one when regard is had to the development of the equitable principle and it is a view shared by a number of commentators.[81] That no judge has gone so far previously is due to the fact that, in equity cases, the precise point in time at which beneficial title passes is of no consequence whereas in the present context it is.

(b) **Income from Property?**

Apart altogether from the foregoing issues, there is a more fundamental question which arises in respect of the efficacy of a taxpayer's attempts to alienate personal exertion income — can it be said that the income subsequently generated is income from property transferred from the assignor to the assignee? Marks argues that it is, in view of the broad meaning given by the law to the term 'property':

> There is no doubt that in its broad meaning 'property' includes, as personal property, a right to receive wages or a salary under a contract of employment, as well as a right to receive a fee or commission for rendering personal services.[82]

Though the right to receive income in future from personal exertion to be rendered will in some cases be a presently existing chose in action, it is doubtful that the source of that future income is the right to receive it; rather, the source of the income is more likely to be the personal exertion of the taxpayer. In *F.C. of T.* v. *The Myer Emporium Ltd*,[83] the High Court stated that the source of interest payments in respect of a loan will never be the contractual right of the lender to receive that interest. Interest flows from the principal sum and this was so notwithstanding that the right to interest may be an existing chose in action capable of present assignment.[84] Can it be reasonably contended that income generated by a taxpayer's exertion is in a different category?

It follows, therefore, that income generated by the personal exertion of a taxpayer may not be validly alienated as the source of that income is not any contractual right to receive it but the personal exertion itself.

5. **Conclusion**

It has been shown that there is presently no authority to support the proposition for which the personal exertion income rule stands — that income generated by a taxpayer's personal exertion is derived by that taxpayer notwithstanding any attempts by the taxpayer to assign that income to another.

Further, Australian courts have, to date, rejected the rule's application to cases in which the legal source of the income has been assigned by the taxpayer to another and the taxpayer thereafter becomes an employee of the assignee, continuing to render the personal services which he formerly rendered.

However, it is clear that in general, it is not possible for a taxpayer to alienate the right to receive income generated by his personal exertion so that he ceases to derive that income. It is in this context, and only in this context, that the personal exertion income rule applies.

---

81. P.J. Kennon 'Assignments of Shares in Professional Practices' (1978) 7 ATRev 12; B. Marks 'Comments on Alienation of Professional Income and on Everett's Case' — a paper presented at the State Convention of the Western Australian Division of the Taxation Institute of Australia, October 1980; J.C. King 'Alienation of Income' (1979-80) 14 Taxn. in Aust. 354 at 413. G.L. Davies 'Recent Developments in Taxation Law and Pointers to the Future — The Case Law' (1980) 10 QLSJ 207; T.W. Magney and P.C. Green 'Thoughts Related to Everett's Case: With particular reference to the Sole Practitioner' (1978-79) 13 Taxn. in Aust. 762.
82. Marks, 339-342 para 707, particularly at p. 340; See also B. Marks 'The Proper Taxpayer in tax Planning; Post Everett' (1980-81) 15 Taxn. in Aust. 512 at 529-531.
83. (1987) 163 CLR 199.
84. *Ibid.* at 217-218.