INCOME AND CAPITAL DISTINCTION[*]

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Distinction between income and capital

It is not surprising that the distinction between capital and income continues to be an object of our attention. The distinction is the most fundamental basis upon which our system of taxation depends. Ours is a tax upon income and not upon capital. The latter is brought to tax only to the extent of a gain and then only upon disposal. It is therefore necessary and fundamental to our system of taxation to determine whether receipts and outgoings have the character of capital or income. Whether a receipt or an outgoing has the character of income or capital will usually be obvious enough, even though we do well to remember that it is the context of the receipt or outgoing that will usually be decisive to its character. However the difference can sometimes be quite difficult to determine and may at times be non existent in economic outcome. Indeed, the economic relationship between capital and income is sometimes so closely interwoven that in economic terms the two are economically indistinguishable. Thus, for example, the capital value of shares cum dividend will be affected by any dividend paid, payable or expected. The very price of shares has a relationship to a company's expected earnings, and the capital value of a business (or of other income producing capital assets like many licences) is likely to reflect future maintainable earnings. In short, we have adopted a basis of taxation upon a distinction which in some cases, and from some points of view, does not exist.

A tax on income was introduced as a Commonwealth tax in 1915 in the context of State and Federal taxation that included taxes and duties on a great variety of matters. Taxes and imposts on items of "capital" could be found in other legislation

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like gift duties, death duties and stamp taxes. The important conceptual idea behind an income tax was, however, that tax should be paid upon a taxpayer's annual income: that is, from a taxpayer's annual fruits, profit or labour, rather than upon the capital or the means by which that income was produced. It was the accountant's annual period that was chosen for calculating the tax, and it was the accountant's concept of a calculated amount of revenue receipts less revenue outgoings that was chosen as the amount upon which to levy tax. It was not a tax on wealth, or upon individual transactions; the tax was upon the regular, recurrent and periodic returns to individual taxpayers, excluding capital receipts and after allowing losses and outgoings properly referable to the derivation of the income over a twelve month accounting period. The system of taxation adopted as a tax upon income, therefore, took as its target the accountant's profit and loss statement (adjusted for tax) rather than the balance sheet. That portion from the profit and loss statement brought to tax was that which represented a taxpayer's annual "income" as determined by reference to "conceptions of the world of affairs and particularly of business".[1] The words "income" and "taxable income" were used as the statutory basis for the exaction, but they referred to more fundamental general concepts found in commerce, business and the ordinary world.

The Courts have frequently said that what is income and what are allowable as deductions are matters of legal analysis[2] rather than for determination by accountants or economists, but saying that does not detract from the fact that the legal questions required by the statutory basis of tax mirrored and gave effect to what is, or at least was, essentially the accountant's calculation of an annual income, profit or loss. The calculation, and its theoretical basis, has not, of course, remained static over time, even in accounting. The system of accounting may owe its modern roots to a Franciscan monk in 1494,[3] but it has changed and evolved over time, in no small part to reflect changes in conceptions in business, commerce and the world of

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1 *The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Limited (Carden's case)* (1938) 63 CLR 108, 152; *Scott v Commissioner of Taxation (NSW)* (1935) 35 SR (NSW) 215; *Reuter v Federal Commissioner of Taxation* (1993) 111 ALR 716, 730.

2 *Carden's case* 152 .

3 See Yorsten, Smyth and Brown, *Advanced Accounting* (10th Ed, 1988) 3-4.

affairs. AAS1 adopted an approach for the profit and loss statement that all realised gains and losses, whether of a capital or a revenue nature, were to be reflected in the statement of profit and loss. Not long ago there was some attempt, only partially successful, to move away from a focus upon the profit and loss statement as the basis of taxation and to look rather to tax the annual differences in the balance sheet. One of the drivers for the change may have been changing concepts amongst accountants and economists about what is likely to give a truer reflection of a taxpayer's, at least a corporate taxpayer's, economic performance from one year to another.[4] The attempted change to the Australian taxing system coincided with a perceived need for greater uniformity in world financial reporting and perhaps a change in the perception in the world of commerce and affairs of what gave a better idea of annual economic performance. Similar changes in the world of commerce and affairs in attitudes over time probably have much to do with the very significant extensions built on to the income tax legislation which had earlier imposed tax upon capital gains, and the many other provisions which have taxed what would otherwise have been capital receipts.

In any event, the distinction between capital and income is so fundamental to the structure of our taxing system that it continues to have effect, even though in some respects the practical consequences may have been blurred by the fact that an item may be taxed whether it be income or capital or that in some cases an outgoing on capital account will be allowable as a deduction. A regularly lamented problem, however, is that of determining a test to distinguish between items on revenue account from those on capital account. In *Heather (Inspector of Taxes) v P.E. Consulting Group*[5] Lord Denning MR said at 216:

> The question – revenue expenditure or capital expenditure – is a question which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy, but in others it is difficult. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other. But this is simply not possible. Some cases lie

4 See *Review of Business Taxation, A Tax System Redesigned*, Report July 1999; esp, pp 2, 9-10, 13-18.

5 [1973] 1 Ch 189.

> on the border between the two, and this border is not a line clearly marked out. It is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in the marginal cases, and then everyone is in doubt. Each can come down either way. When these marginal cases arise, then the practitioners, be they accountants or lawyers, must of necessity put them into one category or the other: and then, by custom or by law, by practise or by precept, the border is staked out with more certainty. In this area, at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is to search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find.

In *Commissioners of Inland Revenue v British Salmson Aero Engines Ltd*[6] Sir Wilfrid Greene MR put it more bluntly by saying that "in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons."[7] However, difficult as it might be to articulate tests for the difference and to give reasons for the conclusions reached, the difference and the reasons still matter. They matter not just because more or less tax may be paid, but because the difference reflects an underlying system adopted for taxation that needs to be understood and applied consistently with principle and with the underlying concepts. In other words, they matter not only because more or less tax will be paid or gathered, but also because they need to reflect, and to give effect to, the underlying policy objectives weaved into the fabric of the legislation.

The tests which have been developed over the years have varied as between receipts and outgoings. In the case of receipts the enquiry focussed upon the occasion by which the receipt was derived; in the case of outgoings the enquiry focussed upon what the receipt secured. A moment's reflection will reveal how much these tests owe to the affairs of business: receipts should be taxed if referrable to the fruits of enterprise; outgoings should be deductible if expended in the process of producing income but not if their expenditure is reflected as part of the continuing capital of the enterprise and capable of subsequent disposal or exchange. On the

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6 [1938] 2 KB 482.

7 Ibid 498.

income side, it was said in *Federal Commissioner of Taxation v Myer Emporium Ltd*[8] in the joint judgment:

> Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income. Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterized as income: *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd*. The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.[9]

On the deduction side, it was said in *Sun Newspapers and Associated Newspapers Ltd v Federal Commissioner of Taxation*[10] by Dixon J:

> There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.[11]

In each case, the enquiry was not what dictionary definition should be given to a word; but rather, what set of criteria best gave effect to the underlying policy chosen as the basis of tax. In that enquiry the words are merely the vehicles through which policy choices are expressed in legislation.

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8 (1987) 163 CLR 199.
9 Ibid 209-210.
10 (1938) 61 CLR 337.
11 Ibid 363.

Even a casual perusal of the legislation and of decided cases will reveal both how important the distinction continues to be and how difficult, and perhaps how controversial, its application can still be to the facts. The legislation continues to maintain taxing differences for receipts and outgoings depending upon their respective character as capital or revenue. The decided cases continue to feature prominently disputes concerning the application of the distinction between capital and income.

Receipts

The decision of the High Court in *Federal Commissioner of Taxation v McNeil*[12] illustrates the continuing relevance of the distinction as well as the continuing difficulty of its application and the controversy[13] around the criteria to be applied. The case concerned the taxability as "income" of a receipt by Mrs McNeil of a mere $514 from the sale on her behalf of rights to sell shares in St George Bank Limited. Mrs McNeil had previously held 5,450 shares in the bank from which she derived dividends over the years and upon which she paid tax in the ordinary way. In January 2001 the bank announced its intention to buy back about 5% of its issued share capital at a fixed price of $16.50 per share. In that context Mrs McNeil came to have 272 rights to require the bank to buy her shares. These rights were separately listed for trading on the Stock Exchange which, at the time in question, had a value of $1.89 each. Mrs McNeil took no steps to exercise her rights, with the consequence under the transaction documents that they were transferred to a merchant bank which sold them to the bank for $2.12 each; a total of $576.64. Part of that receipt was treated as a capital gain, but the bulk, $514, was treated by the Commissioner as ordinary income under general principles.

The occasion by which Mrs McNeil came to have the rights was, from the company's point of view, a return of capital. Mrs McNeil, as a shareholder, and from an accounting and economic point of view, could also be seen to be receiving a part of

12 [2007] ATC 4223.

13 See D.H. Bloom Q.C., 'Taxpayer's Heaven: The Citylink Decision; The Opposite of Heaven: The decision in McNeil' *Convention Papers T.I.A*., Hobart March 2007.

the capital worth of her shareholding upon the sale of the sell-back rights. The High Court, by a 4-1 majority, held otherwise, focussing upon Mrs McNeil's individual receipt of the money and upon a finding that her shareholding remained unchanged as a matter of legal analysis.

The majority judgment in *McNeil* began its consideration of the issues with several preliminary points. The first was that the character of the sell-back rights had to be determined from the point of view of the taxpayer (the recipient) and not from the point of view of the bank (the payer). The second was that "a gain derived from property has the character of income" including a gain to an owner who receives the gain passively.[14] In other words, that an important inquiry relevant to the ultimate issue was whether the gain was derived from property which the taxpayer continued to hold rather than being a receipt in exchange for a disposal of a part of it. This led their Honours to consider whether the rights enjoyed by Mrs McNeil arose from and were "severed from, and were a product of, her shareholding in [the bank] which she retained".[15] Critical to their Honours' conclusion that they were, was their Honours' analysis that Mrs McNeil's shareholding in the bank, as a matter of legal analysis, "remained untouched".[16]

Callinan J reached the contrary conclusion but not necessarily disagreeing with the principles enunciated by the majority. I say "not necessarily" because his Honour did express the view that the character of a payment for the purposes of the definition of income "is not always to be, indeed cannot always be, determined simply and solely by reference to its quality in the hands of a recipient."[17] Such a statement might be thought to be contrary to propositions found in the judgment of the majority, but as a matter of practical application, the difference may not be as significant as might appear, since his Honour's analysis of the "transaction as a whole"[18] (consistent with the principle enunciated in the majority judgment) may be an analysis of the rights in

14 [2007] ATC 4223, 4228.
15 Ibid 4228 [21].
16 Ibid 4228 [22].
17 Ibid 4232 [55].
18 Ibid 4232 [55].

the hands of Mrs McNeil when viewed from the position of Mrs McNeil as a shareholder. On that view, his Honour differed from the majority in application of principle to the facts. That is to say, that the consideration by Callinan J of the character of the sell-back rights in her hands may have given more significance to the fact that she was a shareholder and to the impact of the transaction as a whole upon her as a shareholder. Indeed, it may be implicit from the judgment of the majority that the difference between the two judgments lay in how they saw the impact of the receipt upon Mrs McNeil as shareholder. The conclusion in the joint judgment was that her "shareholding in [the bank] remained untouched";[19] in other words, the outcome might have been different on the reasoning of the majority if they had concluded that her shareholding had been affected materially by the transaction.

The *McNeil* decision may ultimately come to be seen as another application of general principles to particular facts where the parties were in hot dispute about what the facts were or about how they should be construed, rather than a decision marking any change in legal principle. In that context the most significant fact in the conclusion of the joint judgment was that Mrs McNeil's shareholding in the bank "remained untouched". An accountant or an economist may have analysed the transaction quite differently and, on one view, may have seen the transaction from Mrs McNeil's point of view as an affair wholly on capital account (as did Callinan J). On such an analysis, Mrs McNeil, as a shareholder, had a number of shares which (in consequence of that holding), as a matter of accounting and economics, came to receive a portion of its value in cash. The number of shares she held before and after her receipt of cash remained the same, but part of the economic value of her investment in those shares was returned to her (and did so in her capacity as a shareholder) without her doing anything and for no other reason than because she was a shareholder. From her point of view, the accounting and economic consequence of the receipt upon the sale of the rights was that her shareholding was in economic terms, and accounting terms, reduced in value by the amount she received in cash and, on that analysis, a portion of *the value* of her shareholding was

[19] Ibid 4228 [22].

"severed" from the worth of the whole and paid to her in cash. That appears to have been the view adopted by Callinan J when his Honour concluded that if one were "to look only to what [Mrs McNeil] had in her hands", she received money "which effectively gave shareholders access to a component of [capital] that they would not otherwise have had".[20]

The future impact of the case may thus depend upon how two features in the majority decision come to be applied to other facts in later cases. Those two features are, first, the principle that the character of a receipt depends upon its quality in the hands of a recipient, and secondly, the finding that Mrs McNeil's shareholding in the bank remained unchanged. In view of the latter, in the context of the former, the Court's conclusion is an application of settled principle. The difficulties, if there be any, may arise from the fact that the qualities of the receipt in the hands of this recipient may be complicated by the fact that the receipt had some impact on her in her character as shareholder in the company which was making the payment (namely, the payer). In other words, that looking at the character of the receipt in her hands does not change the fact that she was a shareholder in the company making the payment and that, therefore whatever she receives from the company must necessarily reduce the economic worth of what she had as a shareholder by the amount paid to her. Mrs McNeil was not just a recipient of money; she was a shareholder receiving money from the company in which she held shares. The character of the receipt on her hands, therefore, might be thought to include any impact of the payment to her in her hands *as a shareholder.*

One question now to be asked, therefore, is the extent to which the same outcome will be reached in other company sponsored rights issues. There is also some uncertainty about the position of Mrs McNeil, and shareholders in like position, upon receipt of the rights before a sale. The majority judgment said that from the date of issue, Mrs McNeil did not acquire "legal title to her sell-back rights" but rather "at least to the observance and performance of the obligations owed to her under the

[20] Ibid 4233 [56].

deeds poll".[21] What, however, is not clear to taxpayers is the fiscal effect of the receipt of such rights and how, therefore, they are to account for them.

The metaphoric fruit tree

Tax advisers in subsequent cases may also find difficulty with how to apply the metaphor of trees and fruits in explanation of the difference between capital and income used by Pitney J in *Eisner v Macomber*[22], accepted in *Federal Commissioner of Taxation v Montgomery*[23], and endorsed in *McNeil*[24]. In *Berkey v Third Ave Railway Co*[25] Cardozo J warned that "[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it".[26] The metaphor may be helpful when the fiscal issue in dispute depends upon whether the receipt is made in return for part of the severed whole (in which case the receipt can more readily be seen as given in exchange for part of the corpus). It is less helpful when the fiscal issue in dispute depends upon the impact which the circumstances of the receipt has upon its character. In the latter case, the fact that the receipt is not given in exchange for a severed portion of the whole may be taken as a given, and the focus of enquiry shifts to the nature of the receiving rather than to the nature of its source.

It will not always be clear to taxpayers, or to their advisers who must lodge returns and advise upon transactions, when, or how, a receipt may be said to be severed from an item of capital as its fruit rather than its body. There can be no doubt that the payment to a shareholder of part of a company's profits should and will, in the ordinary course, be treated as income. Such a payment will ordinarily be a taxable dividend to the recipient and little further enquiry need be undertaken to dispose of any question about assessability. The same answer need not necessarily be reached, as a matter of fiscal policy, where the receipt does not proceed from a pool

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21 Ibid 4228 [27]. See also Bloom, 'Taxpayer's Heaven'; Justice Richard Edmonds, 'Recent Tax Litigation: A view from the Bench' *Australasian Tax Teachers Association, Conference Papers*, Hobart 23-25 January 2008.

22 252 US 189 at 206-207 (1920).

23 (1999) 198 CLR 639, 660-663.

24 2007 ATC 4223, 4228 [21].

25 155 NE 58 (1926).

26 Ibid 61. See also Justice Richard Edmonds, 'Recent Tax Litigation' [10].

of taxable profits. Indeed, to treat a payment of a company's corpus as taxable, as ordinary income, in the hands of a shareholder may present several fiscal anomalies. Such a payment, for example, would not receive the benefit of company tax imputation (since no company tax was paid or payable upon the corpus) and may produce unexpected capital gains tax outcomes if the shares are eventually sold (since the receipt will not be treated as a reduction in the cost base).

One of the interesting questions which will undoubtedly arise in the future, therefore, is what different facts might cause a court to conclude that a taxpayer's shareholding in the company had *not* "remained untouched". In other words, what variations, if any, to Mrs McNeil's shareholding would have led to the conclusion that there had been a change to the shareholding such that the receipt would have been a return of capital (part of the tree) rather than a receipt proceeding from the capital (the fruit). A strict application of the dicta in *McNeil* would seem to require that part of the capital would need to be disposed of in exchange for the receipt. On this view the issue by a company to its shareholders of any rights, including renounceable rights, would be income under ordinary concepts notwithstanding (of course) that the economic or accounting effect (from the taxpayer's point of view as a shareholder) of the receipt was a reduction in the capital value of the shareholding. A practical question for corporates is how to ensure that the fiscal results, upon a legal analysis, match the economic and accounting outcome of a return of capital. To that enquiry the decision in *McNeil* is a clear warning that formal legal analysis of the basis of the receipt is important.

Passive exploitation of capital

The earlier decision of the High Court in *Federal Commissioner of Taxation v Stone*[27], although not in terms a case about the distinction between capital and income, also has some bearing upon the distinction. In that case the court held that the hallmark of a revenue receipt by an athlete was that she had "turned her talent as an athlete to account for money".[28] The decision was applied by the Federal Court at

27 (2005) 222 CLR 289.

28 Ibid 291.

first instance to allow deductions,[29] and, like *McNeil*, applied the dicta in *Federal Commissioner of Taxation v Montgomery*[30] that:

> [I]ncome is often (but not always) a product of exploitation of capital; income is often (but not always) recurrent or periodical; receipts from carrying on a business are mostly (but not always) income.[31]

The concept that an income receipt may flow from the exploitation of capital is not novel and lies at the heart of many of the decided cases, for example, those finding taxable profits or income from profit making undertakings or schemes. What *Stone* highlights, however, is the importance of the link between a receipt and the exploitation of capital.

The critical concept in both *Stone* and *Montgomery* may have been thought to be the emphasis placed by the court upon the finding of "use", "exploitation" or "bringing to account" of the capital. In *Montgomery*, for example, the court explained its application of the dicta from *Eisner v Macomber* by saying that "the firm used or exploited its capital"[32] to obtain the inducement amounts. So understood, what mattered was not just that the capital had not been severed, but, rather, that the resultant receipt was a product of activity which stamped the receipt with some profit making purpose. In that regard the decision is illustrative of the dicta in *Federal Commissioner of Taxation v Myer Emporium Ltd*.[33] What *McNeil* may add to that analysis, however, is that the circumstance of the capital having remained intact may be sufficient to provide the finding that the receipt had the character of income without the need to find that the circumstances of the receipt had the characteristics of income earning activity. In *Montgomery* and *Stone* it was the <u>exploitation</u> of the (intact) capital that stamped a profit making purpose upon the receipt, but in Mrs McNeil's case, she had been entirely passive (a circumstance pointed out in the joint judgment as being insufficient to deny a receipt the character of income).

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29 *Spriggs v FCT* [2007] ATC 5280; *Riddell v FCT* [2007] ATC 5293; although subsequently overturned on appeal see *Commissioner of Taxation v Spriggs; Commissioner of Taxation v Riddell* (2008) 170 FCR 135.

30 (1999) 198 CLR 639.

31 Ibid 663 [68].

32 Ibid 678.

33 (1987) 163 CLR 199, 209

Taxpayers, and their professional advisers, may now need to consider many other receipts hitherto not thought to be brought to tax as income when lodging returns. Amounts received, for example, in restraint of trade upon the sale of a business, which many may have thought taxable only as a capital gain (and perhaps only in the extended operation of those provisions), may need to be reconsidered in light of *McNeil*.

Legal analysis of capital holding

The decision in *McNeil* highlights the difficulty which has frequently been expressed about the application of the tests to determine whether a receipt be on capital account or on income account. The requirement emphasised in *McNeil* that the character of the receipt must be determined by its character in the hands of the recipient[34] is unsurprising because the character of income will frequently depend upon the context of the receipt rather than the formal circumstances of the receipt itself. Thus, for example, the character of the receipt from the sale of a motor car may differ as between a sale by a motor car dealer and a sale by an average member of the general public. Ultimately what was in issue in *McNeil* was how to determine the character of the receipt in the hands of Mrs McNeil given that she was a shareholder. The majority judgment rests upon the view that the receipt in her hands was to be determined by the fact that what had given rise to her receipt, namely her shares, were formally unaltered in legal character and quality by the occasion for the payment. On that basis the receipt was seen to flow from something which was unaltered by the payment. The formal analysis adopted by the majority judgment was of the shares which gave rise to the entitlement which, as they concluded, remained unaltered upon the sale of the buy back rights for the receipt. A simpler route may have been that taken by Callinan J's dissent which may, perhaps, better reflect the economic outcomes of the transaction from Mrs McNeil's point of view. However, it is doubtful that all receipts to a shareholder from a company where the shareholding remains the same in number will result in the same outcome as in *McNeil*. If, as is trite law, the character of the receipt

34 *Federal Coke Co Pty Ltd v FCT* (1977) 15 ALR 449, esp at 457.

depends upon its character in the hands of the recipient/shareholder, then it is relevant to inquire whether what the receipt proceeds from remains unchanged by the occasion of the payment.

Deductions

The capital and income distinction continues also to be relevant to determining what are allowable deductions. Capital losses are not usually deductible against income receipts and the character of an outgoing as either being on revenue account or on capital account can have profound consequences for fiscal policy. The legislative amendment and line of litigation involving convertible notes or instruments with a component of deductible outgoings are illustrative of this.[35] The more recent cases involving financiers raising tier one capital with an interest component to the instrument through which the funds are raised illustrates the continuing importance of the distinction between capital and income.

The raising of capital, whether by a financier or any other taxpayer, carries with it a cost: investors buying shares expect a return on their investment and lenders who have lent money similarly require an economic return on the funds advanced. From the point of view of the taxpayer raising funds, there is a cost whichever way the funds are raised, but the cost is different depending upon whether the funds are obtained as loans or as contributions to equity. Similarly, from the point of view of the provider of funds (whether as investor or as lender) there will be an expectation of preserving capital as well as an economic return upon the capital, but there will be a difference in expected risk and return depending upon whether the funds are provided as investor or as lender. The parties regulate their dealings to share or minimise risks and returns by the kind of transaction they enter into. At one level the difference between the transactions is a difference about the nature of the risk exposure undertaken by the provider of the funds and the degree to which a company is willing to share the rewards of its risks and endeavours with those who have provided the funds.

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[35] See for example *MacQuarie Finance Limited v Commissioner of Taxation* (2004) 210 ALR 508.

These differences may be of interest to accountants and economists but they are critical to the tax adviser because of the fiscal consequences which flow from the different character assumed by each kind of transaction. The investor risks capital into a corporate venture and generally has no legal right to require repayment of the capital as such. In return for that risk, however, the investor will generally be entitled to share in the fruits of the venture through dividends (that is, through a distribution of the division of profits amongst the shareholders). The lender, on the other hand, assumes a different risk to that of an investor and will generally be entitled only to a financier's return on capital without reference to the profitability of the use to which the funds have been employed, and will generally have a legal entitlement to require repayment of the moneys lent. The cost to the person acquiring the funds (whether by share issue or as a borrowing) will be treated as either an affair of capital or as an affair of revenue with an important consequence for the cost of capital and for the public revenue. If the cost be on capital account it will generally not be deductible and, therefore, it will, to that extent, be more expensive than if the outgoing were deductible.

A consideration of the cases in this area might suggest (at least superficially) that the law has been excessively concerned with the legal form of a transaction rather than with its substance. There are many observations in the decided cases, however, which explain why the form is important and why it may be difficult to rely upon broader notions of substance.[36] On the other hand a mere interpretation of a transaction by reference to its form may say nothing about its nature. In *Lomax v Dixon*[37] Lord Greene MR observed:

> In many cases, however, mere interpretation of the contract leads nowhere. If A lends B 100*l* on the terms that B will pay him 110*l* at the expiration of two years, interpretation of the contract tells us that B's obligation is to make this payment. It tells us nothing more.[38]

The 110*l* difference in the payment could be capital or it could be interest. Considerations of that kind arose in cases like *MacQuarie Finance Ltd v Federal*

36 See for example *ANZ v FCT* (1993) 114 ALR 673, 696; and *Reuter v FCT* (1993) 111 ALR 716.
37 [1943] 1 KB 671.
38 Ibid 675.

Commissioner of Taxation[39] where considerable fiscal and commercial consequences flowed from a determination of whether the payment of an obligation described as interest was to be seen as on capital account: that is, as a return upon the capital rather than a cost in the derivation of income. An economic consequence of allowing deductibility of the "interest" component of the payment under a perpetual Tier 1 instrument is that the economic cost to the taxpayer of its capital is reduced by the tax effect of the deduction. Another economic consequence of allowing a deduction is to shift from the shareholders to the public revenue the economic burden of that amount of the cost of capital raising that is effectively part of the economic return to the shareholder/lender for the risking of funds. In other words, that an economic consequence of allowing deductions is that the payment of the "interest" component to those providing the funds is akin to a tax deductible dividend by the company making the payment. In the *MacQuarie* case Hill J, at first instance, and the Full Court on appeal[40], sought to determine the substance of the transaction flowing from the legal rights created.

Debt/Equity Provisions

The legislature has sought to reduce the apparent significance for tax purposes of the legal form in relation to debts but has not done away with distinction: it continues to be the determinative criteria for deductibility. The difficulty of determining whether an outgoing is to be treated as on a capital or revenue account, however, has been made no less difficult by the enactment of the debt equity provisions found in Division 974 of the 1997 Act. The purpose of those provisions is to make the character of an outgoing depend less upon the legal form of the transaction than upon its economic substance. That of course does not mean that the legal rights will not determine the character of an instrument under the debt and equity rules but that there has been a shift in which legal considerations are likely to govern the proper characterisation of transactions for revenue purposes. The provisions are too complicated to deal with on this occasion but, in general terms, what they are designed to achieve is a shift in

39 (2004) 210 ALR 508.
40 [2005] ATC 4829.

the focus of enquiry from whether there is, for example, the legal form of debt on which principal and interest is payable, to a consideration of whether the legal relations created between the parties expose the provider of funds to the kinds of risks one would expect to be assumed either by an equity participant or by a lender.

This very broad objective is sought to be achieved by significantly complex and lengthy provisions which may have produced a much greater degree of uncertainty than may be justified given the state of the law, and its impact, hitherto. One of the critical elements, for example, is whether the acquirer of funds has an "effectively non-contingent obligation" under "a scheme" to provide a financial benefit or benefits to one or more entities. The statutory criteria of an "effectively non-contingent obligation" requires consideration of a variety of factors. One of them, in s 974-135(5), is that an obligation is not contingent if it is not contingent on any "event, condition or situation (including the economic performance of the entity having the obligation or a connected entity of that entity), other than the ability or willingness of that entity or connected entity to meet the obligation". The precise meaning and effect of these words is yet to be finally determined, including the way that the words "effectively non-contingent" qualifies the word "obligation" as distinct from such other word like "performance". The words in the parenthesis in s 974-135(5) and above might be thought to suggest that the contingency of an obligation may depend upon economic performance of the obligation, although it is difficult to see why that should be, since an ability to pay a simple debt will often depend, as a matter of practical reality, upon the economic performance of the borrower having an ability to repay. For present purposes however, I can leave these complex provisions with the simple observation that the distinction between capital and revenue continues to be alive (if not well).

The main target of the debt/equity provisions are, as I have said, to change the rules by which to determine the deductibility of what otherwise might have been regarded as deductible debt on established legal analysis. In doing so, the legislature has declared an intention that deductibility is in somewhat greater part to be decided by

economic consideration than the law had previously allowed. These provisions must, of course, be complied with, but the theoretical basis upon which they depend needs to be understood (if that be the right word) and questioned. It needs to be understood in the hope that an understanding of the premise might enable taxpayers, regulators and the courts to give effect to parliamentary intention. Perhaps it is also for the same reason that it needs to be questioned. A fundamental problem with an application of any test to determine the difference between debt and equity is that at the margins (if not at its centre) the difference is at times economically non existent. The law's response in making the difference depend upon the form of obligation may not much be liked by some, but the tests ushered in by the debt/equity provisions may, in the end, yield little benefit.

To these broad considerations may be added that the need to distinguish between capital and income in hitherto financing instruments may, in the future, arise in an unexpected context. I am not an expert in Islamic law but I gather that it prohibits the charging of interest.[41] A consequence of this, in the reality of a need to obtain or place funds, is that Islamic financiers have developed a series of financing structures which enable financiers to provide funds in return for some return upon those funds which, however, do not amount to interest under Islamic law. Some of these financing structures result in the bank receiving a share in profits, fees or sales proceeds.[42] The principles of Islamic banking may seem complex to a non-Islamic lawyer, although the financing structures employed bear some similarity to financing instruments typically encountered in Australia. They do seem less complicated than the debt and equity provisions which, for its part, may have some difficulty coming to terms with Islamic instruments when they come to be applied to them; to say nothing of the many interesting conflict of laws questions that may arise.

Practical and business point of view

In the meantime this most fundamental distinction in tax law continues to be a cause of battle between taxpayer and Commissioner in critical areas of a taxpayer's

41 Jamila Hussain, *Islamic Law and Society* (1999) 177.

42 Abdullah Saeed, *Islamic Banking and Interest* (2nd ed, 1999).

business operations. In *Federal Commissioner of Taxation v Citylink Melbourne Ltd*[43] the High Court upheld the deductibility of concession fees payable, but not paid, under a contractual arrangement. The deductibility of the amounts would doubtlessly have had an impact upon the economic performance of the business and critical to the Court's decision was the finding of a legal liability being incurred under the relevant contract notwithstanding that the amounts were not payable for some time.[44]

In *Star City Pty Ltd v Federal Commissioner of Taxation*[45] the commissioner had disallowed, as being on capital account, the payment of a contract amount for rent. In *Tyco Australia Pty Ltd v Federal Commissioner of Taxation*[46] he disallowed, again as being on capital account, fees paid to dealers who secured contracts for security services upon assignment of the contracts to the taxpayer. In both cases the Commissioner was unsuccessful. In both cases their Honours were called upon to consider first principles and to apply them to the particular facts before them. In each case their Honours were called upon to consider the substance of the outgoing by reference to its place within the taxpayer's business operation. It would not be appropriate for me to comment upon the merits of either case given my involvement for both taxpayers but it is interesting to note that both cases were disputes about the application of first principles. In *Tyco* Allsop J said:

> 75 It is uncontroversial that the payment of the Assignment Fees led to an acquisition of rights by TAPL by assignment and novation. Those rights can be seen to be assets purchased by TAPL. The price of the assignment of the assets was, under first two versions of the Authorised Dealer Agreement, equivalent to almost all of the revenue stream inherent within the term of the rights assigned, and, under the third version, about two thirds of all the revenue stream within the term of the rights assigned. Thus, TAPL could be said to have been buying bundles of rights so that it might profit from the acquisition of the person with whom the assigned contract is made, as a customer, beyond the three year term. Mr Brown said as much.
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> 76 This does not make this an affair of capital. The asset or the so-called accretion to structure was, in practical and business terms (and in legal terms), the winning of a customer. That a very attractive (to the

43 [2006] ATC 4404.
44 Ibid, 4425-6.
45 [2007] ATC 5216.
46 [2007] ATC 4799.

Authorised Dealer) Assignment Fee was set reflected the anticipation not of the value of the contract rights themselves that were assigned, but rather the future value of the connection with the customer and the future revenue stream once the customer was won. The advantage sought by each payment was the winning of a customer, so that he, she or it might be retained and exploited (using that word in a neutral sense) for future revenue for services to be provided.

77 The Assignment Fee was set so attractively that TAPL obtained, very quickly, more customers than anticipated. There was a concomitant side-effect of many customers cancelling, no doubt, at least in part, a product of eager door-to-door selling by Authorised Dealers remunerated in the manner they were. I do not infer from the evidence, as the respondent submitted I should, a plan to acquire such an initial mass of customers, irrespective of quality, to place the institution of the AD Program as the equivalent of buying a book of business in one transaction (such as was done from Honeywell). None of the evidence reveals such a plan. By the winning of customer by customer (in significant numbers) TAPL built up its customer base and its hoped for future revenue. It is important to recognise that each Assignment Fee was payable in respect of each Customer Service Agreement assigned and novated. Each assignment and novation and each passing of a customer to TAPL was an incremental accretion to the customer base of TAPL. This distinguishes the payments (as a collection of individual payments) from the purchase of a book of business as was involved in the Honeywell transaction.

78 The fact that the Assignment Fee was, under the first two versions of the authorised Dealer Agreement, almost the whole of the contracted revenue stream, and, under the third, about two thirds of it, may say something about the initial commercial wisdom of the setting of the Assignment Fee, but it does not persuade me that the payments were on capital account. It highlights that the advantage sought was the winning of the individual customer and the hoped-for future revenue after the initial three year period which might be brought about once the connection was made. Looked at in this way, the expenditure of money was in the ordinary business activity of winning customers. It is an illustration, perhaps, of the fineness of the judgment that needs to be made (the "basal difficulty" as Dixon J called it in *Sun Newspapers* 61 CLR at 360) in characterising the method used to increase the extent, condition or efficiency of the profit-yielding subject when that can be seen to be effected by the course of operations. This is especially so in a business whose structure and value is based on the attachment and goodwill of customers for the provision of services or the supply of goods.

79 When one steps back from each individual assignment and places the AD Program in its context, it amounts to one business method of seeking out, contracting and profiting from additional customers. It could have been done by many methods, including employees, commission agents or, as here, independent contractors, going out to obtain customers. The instrument used (whether employee, agent or independent contractor) would need to be remunerated. The method of remuneration does not affect the character of the advantage sought: the incremental addition to the customer base of TAPL and the future obtaining of revenue therefrom. The substantive commercial effect of the arrangement, which was entirely

conformable with the legal arrangements between TAPL and the Authorised Dealers, in particular concerned with training and marketing and with the representation of the place and role of ADT, was that the Authorised Dealers and their agents operated as a marketing sales force for ADT to find and win customers. This can be seen in the arrangements for seeking out Authorised Dealers and supporting and controlling their marketing. The Authorised Dealers were not only under regulation as to how they marketed, but their place as Authorised Dealers were subject to 90 days' notice. See, in particular in this regard, [12]-[15] of Mr Brown's affidavit.

80 I do not agree with the respondent's submissions that these considerations are irrelevant to the characterisation of the payments. They are part of the whole context of the business activities of TAPL in which the character of the advantage sought by TAPL in making the payments is to be assessed. The characterisation of what TAPL was getting by making the payments of the Assignment Fees is assisted by understanding other equivalent ways of obtaining the same advantage. The same advantage could have been obtained by use of employees (as had been done) or by the use of commission agents. In each case, a relationship between TAPL and the customer could have been brought about.

81 This was not the purchasing or creation of a business structure. It was, to paraphrase and elaborate upon the words of Dixon J in *Sun Newspapers* 61 CLR at 360, the building of the extent of the profit-yielding subject (being the customer base of TAPL) as the product of the course of operations, by the incremental winning of customers by the chosen method of organising and remunerating an independent, but controlled, sales force.

82 I do not think that the accounting treatment undertaken by TAPL assists greatly. The booking of payments as an asset, amortised against the profit and loss account, can be seen, from the perspective of company accounting, as assisting the perception of profitability. However, this accounting treatment does not necessarily mean that the payments were an affair of capital. First, as a matter of principle, the accounting approach cannot be determinative of the issue: *Commissioner of Taxation of the Commonwealth of Australia* v *James Flood Pty Limited* (1953) 88 CLR 492; *Arthur Murray (NSW) Pty Limited* v *Commissioner of Taxation of the Commonwealth of Australia* (1965) 114 CLR 314 at 320; and *Commissioner of Taxation* v *Citibank Limited* 93 ATC 4691; (1993) 44 FCR 434 at 443-44. Secondly, there was no explanation in the evidence or submissions as to whether the accounting treatment might be equivocal about whether the payments reflected fixed or circulating capital. Thirdly, the questions whether or not the payments should be treated in the way they were to match outgoings to revenue (cf *Coles Myer* 176 CLR at 666), and how one could, or should, account for such a requirement, were not explored, either in the evidence or the submissions. In these circumstances, it is unnecessary, and probably unhelpful, to restructure any analysis around the concepts of fixed and circulating capital, or any like concept: cf. Parsons RW *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* (Law Book Co 1985) pp 155ff and *passim.* In this respect, I would simply cite and adopt the approach of Gibbs J (as he then was) in *Commercial and General Acceptance Limited* 137 CLR at 377:

> "I think the proper approach is to apply directly the tests suggested in [*Sun Newspapers* 61 CLR 337 at 359-363], for the purpose of deciding whether the repayment was an expenditure referable to capital account or to revenue account, rather than to consider whether the moneys borrowed, when received, became circulating capital. The line of distinction between fixed and circulating capital is not precisely drawn, and it is of little advantage to try to answer one question by asking another to which the answer may be uncertain: cf *John Smith & Son* v *Moore* [1921] 2 AC 13 at 19-20 per *Viscount Haldane, and Crompton* v *Reynolds and Gibson* [1952] 1 All ER 888 at 895 per Lord Reid.".

> 83 As to the second and third aspects of the advantage referred to by Dixon J in *Sun Newspapers* 61 CLR at 363, being the manner in which the advantage sought was to be used in the business and the means adopted to obtain the advantage, these considerations are bound up with what I have already said. The advantage obtained was the addition of each customer to the business of TAPL. This was to be used in the continuous and recurrent task of providing services during, and hopefully after, the contract period. The means adopted to obtain the advantage was the payment of each Assignment Fee as the cost of acquiring each customer to whom the services would be provided and from whom revenue would be extracted. This was an incremental recurrent activity brought about by the activity of the group of people charged with the responsibility of finding individual customers for TAPL.

> 84 In my view, the payments in question were on revenue account.

In *Star City* Gordon J also took as her starting point the observations of Dixon J in *Sun Newspapers*. Her Honour concluded that an application of those principles led to the conclusion that the outgoing was deductible as being on revenue account.

A feature in *Star City* of interest is that the outgoing was a prepayment for the use of the land over 99 years. Her Honour concluded from the transaction documents that the payment did not secure an enduring asset other than the use of the premises over time. Her Honour said:[47]

> 92 Although the Prepayment was a one-off payment and was non-refundable in the manner described, it is necessary (as Hill J described) to go further and examine the character of the advantage sought in making the Prepayment: (1) what was the Prepayment really paid for? and (2) is what it was really paid for, in truth and in substance, a capital asset?

> 93 The Prepayment was described in the Construction Lease and the Freehold Lease as being referable to the "Primary Rental Period": see Construction Lease, Sch 1.1 ([30] above) and Freehold Lease, Sch I(a) ([43] above). The "Primary Rental Period" was 12 years. The rent

[47] At [92]-[96].

payable was expressed as an annual rent of $15,000,000 each year. The rent for the "Primary Rental Period" was prepaid by the Prepayment of $120,000,000, being the net present value of 12 years rent at $15,000,000 per annum: Construction Lease at Sch 1.3. The rent of $15,000,000 per annum was fair market rent.

94 The fact that the rent was paid by way of a lump sum does not detract from the fact that rent was paid to secure the use of the Premises for the period to which the payment related. Unlike the vendors in Cliffs International and Colonial, here the State retains title to that part of the profit-yielding structure from which Star City derives its income; the Premises were merely made available for use by SHCP for the duration of the Primary Rental Period. In addition to not receiving title to the Premises at the end of the lease term, SHCP received no option to purchase (whether at a below-market price or otherwise), and it was not suggested that 99 years constitutes all or a major portion of the life of the Premises.

95 In short, the Prepayment did not secure any enduring asset: neither Star City nor any other entity acquired the land or the buildings which comprised the Premises: see South Australian Battery Makers at 655 (per Gibbs ACJ).

96 Instead, the payment secured the use of the Premises for the purposes of generating income from the casino. There was no allegation and could be no allegation that the Prepayment of rent was a sham. The two leases (the Construction Lease and the Freehold Lease) were necessary and existed, the rent was an agreed amount, was payable and was paid. Although labels can never be determinative (*Jupiters Ltd v Deputy Commissioner of Taxation* (2002) 118 FCR 163 at [26]; South Australian Battery Makers at 655 and *Commissioner of Taxation (Cth) v Broken Hill Pty Co Ltd* (2000) 179 ALR 593 at [36]), the Prepayment was in this case, as it was described - a prepayment of rent.

Her Honour rejected an argument put by the Commissioner that the capital nature of the outgoing was to be seen from the surrounding circumstances in which the transaction was entered into. In that regard her Honour said:

101 The "surrounding circumstances" or "background" relied on by the Commissioner is irrelevant to the proper characterisation of the Prepayment because the advantage sought by the Prepayment is capable of identification and characterisation by reference to the Leases and the Occupational Licence Agreement and, if necessary, the Transaction Documents as a whole: *City Link* (Federal Court) at [44]-[45], approved by *Citylink* (High Court) at [120], [151] and [154].

102 Moreover, even if the "surrounding circumstances" or "background" were examined, they do not alter the identification of, or the character of, the advantage sought by the Prepayment. The three documents referred to in [100] above cannot be said to constitute the "whole factual matrix of which the [Leases and the Occupational Licence Agreement] forms part": *FCT v Cooling* (1990) 22 FCR 42 at 51-53 citing *Duke of Westminster's Case* [1936] AC 1. The documents by their nature and content do not form part of the factual matrix. None of

> the documents was sent by one contracting party to any other contracting party or was executed by the contracting parties. I considered the letter sent by Star City to the NSW Treasurer on 13 December 1994 in pars [61] to [63] above. The issues identified in relation to that document apply equally to the 19 April 1994 and 27 April 1994 letters. Moreover, even if the documents did form part of the factual matrix, they form just that - only part. It is not open to either party to pick and choose from the factual matrix.

What was critical to her Honour's outcome was a detailed analysis of the legal rights and obligations of the parties to determine what they secured.

The Full Federal Court on appeal unanimously reached the opposite conclusion, with the potential for interesting consequences in other cases. Each judge in the Full Court considered that her Honour at first instance had not given sufficient regard to what the prepayment was calculated to effect from "a practical and business point of view".[48] The origin of the phrase may, perhaps, be traced to a passage in the judgment of Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation*[49] where his Honour said:

> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.

It is clear from this passage that his Honour was emphasising the importance of a practical and business point of view to determine the consequences of deductibility in rejection of the view that a juristic classification of the legal rights would exclusively determine the fiscal consequence of an expense or outgoing. In other words, for example, that the fiscal consequences of an item of expenditure would not depend upon whether the taxpayer acquired something that was juristically an asset (such as real estate, or shares), but rather upon what role was played by what was secured in the business operations of a taxpayer. This point was explained by Allsop J in *Tyco Australia Pty Ltd v Federal Commissioner of Taxation*[50] where his Honour said:

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48 *Federal Commissioner of Taxation v Star City Pty Ltd* [2009] FCAFC 19 at [38] per Goldberg J, [196] per Dowsett J and [255] per Jessup J.

49 (1946) 72 CLR 634 at 648.

50 (2007) 67 ATR 63 at 74.

> The mere identification of the correct description of the legal rights obtained or transferred by any transaction is generally too narrow a focus for the answering of the question. This is especially so once it is recognised that almost every commercial arrangement based on contract can be analysed jurisprudentially from the perspective of buying and selling rights or choses in action. Such rights are merely the legal or juridicial building blocks of relationships built from business and practical activity. The enquiry as to whether an outgoing is on capital or revenue account looks to the business and practical effects and advantages sought in the whole context …

It follows, therefore, that what may in at the hands of one taxpayer be an item of capital may be an item of income at the hands of another. The use by Dixon J in *Hallstroms* of the phrase "practical and business point of view" was in terms a reference to the context from which the inquiry about characterisation was to be undertaken, as was emphasised by Crennan J in *Commissioner of Taxation v Citylink Melbourne Limited*[51] when her Honour said that the characterisation of what an outgoing is calculated to effect is "to be judged from" a practical and business point of view.

The observations by Dixon J in *Hallstroms* were not in their terms articulating a criterion of deductibility upon general motions of whatever might be thought to be a practical or business effect. It was, rather, a rejection of the proposition that the fiscal question would depend upon a simple juristic classification of the legal rights secured, employed or exhausted in the process of gaining or producing assessable income. It was, and is still, relevant, and necessary, to inquire into the legal rights, if any, secured, employed or exhausted in determining what effect they have on a taxpayer when viewed from the standpoint of practical and business effects. In that inquiry the juristic classification of the legal rights secured, employed or exhausted in the process will necessarily have a part to play. That too was emphasised by Crennan J in *Commissioner of Taxation v Citibank Melbourne Limited*[52] where her Honour said (immediately after noting that the characterisation of what an outgoing was calculated to effect was to be judged from a practical and business point of view):

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51 (2006) 228 CLR 1 at 43, with whom Gleeson CJ, Gummow, Callinan and Heydon JJ agreed.

52 (2006) 228 CLR 1 at 43.

> The character of the advantage sought by the making of the expenditure is critical.

A detailed enquiry into the character of the advantage is, therefore, necessary. In making that enquiry it will be essential to determine the legal rights obtained as part of the process of evaluating what effect they will have in the taxpayer's business.

At first instance her Honour had concluded that the taxpayer had by the payment secured the use of premises for the purposes of generating income. Each of the judges on appeal took a different view. Goldberg J said that the view of the primary judge had not sufficiently taken into account that the rent was prepaid as a lump sum and was also not refundable unless the parties agreed to terminate the lease and agreed to refund part of the rent in respect of the unexpired term of 12 years.[53] The disparity of the amounts payable as between the first of 12 years and the remaining 80 years was said by his Honour to indicate that "the advantage sought by the lump sum prepayment was the obtaining of the exclusive right to operate a casino for 12 years".[54] Dowsett J characterised the advantage of "the upfront payment of rent" as part of "the package, including the award of the licence and the benefit of the exclusivity arrangements" which his Honour took the view could only be regarded as of capital or of a capital nature.[55] Jessop J concluded that approaching the matter from a practical or business point of view what Star City acquired by the payment of the amount in question "involved a great deal more than the conventional exchange of rent for a right of occupancy".[56]

I say nothing about the correctness of the decision in that first instance or on appeal. The distinction between capital and income is difficult enough and it may suffice for my purposes to draw attention to the disagreements between experienced tax advisers and the commissioner evident in the litigation and in the subsequent decisions. What may be thought difficult about the decision of the Full Federal Court, however, is the potential uncertainty about what it was about the advantage obtained

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53 *Commissioner of Taxation v Star City Pty Ltd* [2009] FCAFC 19 at [50].
54 Ibid, at [54].
55 Ibid, at [196].
56 Ibid, at [256].

by the payment by the taxpayer that ultimately tipped the balance in characterising the payment as capital. It is hardly surprising that a taxpayer would be prepared to pay as ordinary commercial rent a large sum if it expects to conduct a business profitably. In such circumstances it is again, perhaps not surprising, that the amount which a taxpayer is prepared to pay as ordinary commercial rent will be greater during a period in which a special or particular feature of the premises is that a taxpayer will be able to use the premises in a particular way that will render it particularly profitable. What, after all, does the quantum of rent by a commercial taxpayer reflect if not the estimated economic return from the profitable use of the specific premises with its special characteristics during the time of rental? To describe the advantage obtained by Star City in such general terms as the acquisition of an exclusive right, or as a package including exclusivity arrangements, or as securing something more than a conventional exchange of rent for the right to occupy, may ultimately not assist in understanding what it was about the nature of the advantage here obtained that might provide guidance in other cases. One is also left to wonder what evidence (whether of fact or expert opinion) might be relevant to inform a judicial decision concerning what a decision maker is to observe when characterizing the advantage obtained by its effects from a business or practical point of view. Expert economists may well disagree about the nature of advantages like those secured by Star City but, on one view, it may have paid no more than commercial economic rent for the future maintainable profits expected for the use of the premises over the 12 year period for which the relevant prepayment was made.

Tax Law and Albert Einstein

Many more cases could be added to the list of disputes which continue to arise about the application of the distinction between capital and income. Those I have chosen may, however, suffice to make the point that it continues to be relevant and continues to be in dispute.

The many cases which have considered the distinction between capital and income, and the learned erudition with which the distinction is so clearly explained, reminds

me of a comment once made by Chaim Weizman after a lengthy voyage he took with Albert Einstein. The two travelled together for nearly two months as part of Einstein's series of lectures in the United States during which he made personal appearances to raise money for the establishment of the Hebrew University which opened four years later. Weizman was frequently asked whether he understood Einstein's theory of relativity and replied that during the long voyage together across the Atlantic "Einstein explained his theory to me every day and on my arrival I was fully convinced that he understood it".

The distinction may be difficult to apply, but it continues to be important, and, it continues to be a source of dispute. It is ironic to observe what Justice Hill said in the very first paragraph of his decision in *Federal Commissioner of Taxation v Brewing Investments Ltd*.[57]

> Just as it seems that the present system of business taxation involving the concept of assessable income less allowable deductions is to be replaced by what is said to be a more commercially acceptable approach to the computation of taxable income, the Court is presented with an appeal which concerns issues which have bedevilled the present conventional system of taxation for at least a century and yet have still not been completely resolved.

The case was not strictly about the distinction between capital and income but its sentiments apply to those disputes with equal force, and with equal lament.

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[57] (2000) 100 FCR 437 at 438; I thank Mr S. McMillan for reminding me of this passage recently.