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Abstract
There has been considerable speculation as to whether inducement payments by landlords to tenants are taxable, either as income according to normal principles, or as assessable capital gains under Part IIIA of the ITAA. This issue has now been partially clarified by the Full Court of the Federal Court in Cooling's case. In that case the court held that one such payment was assessable as income on the principles enunciated in Myer's case. The court went on to express the view that, even if it had not been assessable as income, it would still have been assessable under s160M(7) ITAA as a capital gain. In arriving at this latter proposition, the court has raised some ominous questions as to the scope of that section.

Keywords
capital gains, income, leases

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THE EFFECT OF THE DECISION OF THE FULL COURT OF THE FEDERAL COURT IN *COOLING'S* CASE

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There has been considerable speculation as to whether inducement payments by landlords to tenants are taxable, either as income according to normal principles, or as assessable capital gains under Part IIIA of the ITAA.[1] This issue has now been partially clarified by the Full Court of the Federal Court in Cooling's case.[2] In that case the court held that one such payment was assessable as income on the principles enunciated in Myer's case.[3] The court went on to express the view that, even if it had not been assessable as income, it would still have been assessable under s 160M(7) ITAA as a capital gain. In arriving at this latter proposition, the court has raised some ominous questions as to the scope of that section.

On 28 June 1990 the Full Federal Court delivered its decision in *Federal Commissioner of Taxation v Cooling*.[4] This is the first time the Full Court has had cause to try and interpret the terrible twins of Part IIIA,[5] and one of the few times it has had the opportunity to consider the effect of *Federal Commissioner of Taxation v Myer Emporium Pty Ltd*[6] on the concept of income under s 25(1).

The facts in *Coolings's* case[7] were simple. Mr Cooling was a partner in a Brisbane law firm. The firm had been approached by letting agents to relocate their practice by taking a lease in a building called 'Comalco House'. Certain inducements were offered by the developer, AMP Society,

1 *The Income Tax Assessment Act* 1926-1990 (referred to in this paper as the ITAA).
2 *Federal Commissioner of Taxation v Cooling* (1990) 90 ATC 4472 (referred to throughout this paper as *Cooling's* case).
3 *Federal Commissioner of Taxation v The Myer Emporium Ltd* (1987) 163 CLR 199 (referred to throughout this paper as *Myer's* case).
4 90 ATC 4472.
5 Sections 160M(6) and (7) ITAA.
6 (1987) 163 CLR 199.
7 90 ATC 4472.

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in consideration of the relocation. Eventually a lease was entered into by the firm's service company, Bengil Services Pty Ltd, and the AMP Society. The partners in the firm gave personal guarantees of Bengil's obligations under the lease. At the time of execution of the lease the firm received from the AMP Society an inducement payment of $162,000, from which Mr Cooling received $21,060 as his share. Mr Cooling described this payment in his tax return as being:

> ... an incentive to procure (Bengil) to accept a ten year lease from (AMP Society) and to guarantee the performance by (Bengil) of its obligations under the lease.

Later, under cross-examination, Mr Cooling described the payment in somewhat different terms, namely:

> The fact was it was an inducement for us to shift and to take a lease.

The trial judge found, as a matter of fact, that the payment constituted an inducement to the firm to move premises and not an incentive for the purposes referred to by the taxpayer in his return.[8] This finding was not interfered with on appeal. Notwithstanding this, the Full Court unanimously found the payment was 'income' as it was the product of 'a commercial transaction' entered into as part of the firm's 'business activity' and for 'a not insignificant purpose . . . [of] . . . obtaining a commercial profit'.[9]

In arriving at this conclusion the court was heavily influenced by the unanimous decision of the High Court in *Myer,*[10] where it was stated:

> 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 transaction entered into otherwise than in the ordinary course of carrying on the taxpayer's business is not income.[11]

> The authorities establish that a profit 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 profitmaking by the means giving rise to the profit.[12]

In *Cooling's* case[13] the Full Federal Court again rejected the view that *Myer's* case[14] had established any new principle whereunder all gains made by a business entity are assessable as income. In this regard *Cooling's* case[15] accords with the earlier approach to *Myer's* case[16] by the Full Federal Court in *Federal Commissioner of Taxation v Spedley Securities*

8 Had Spender J accepted that the payment had been correctly described in the taxpayer's return then the payment would almost certainly have been income according to ordinary principles and assessable under s 25(1) ITAA.

9 See 4484 of Hill J's reasons for judgment in *Federal Commissioner of Taxation v Cooling* 90 ATC 4472. These reasons were endorsed by both Lockhart and Gummow JJ, who did not deliver separate reasons on this issue.

10 (1987) 163 CLR 199.

11 Ibid 209.

12 Ibid 210.

13 90 ATC 4472.

14 (1987) 163 CLR 199.

15 90 ATC 4472.

16 (1987) 163 CLR 199.

Ltd[17] and numerous other first instance decisions handed down since *Myer's* case.[18]

It would seem that the effect of *Myer's* case,[19] as interpreted to date, may be summarised as follows:

(a) Unusual or extraordinary gains made by a taxpayer may amount to income even though they did not arise out of the ordinary course of the taxpayer's business and/or resulted from the sale of a capital asset.[20]

(b) To constitute income, such gains must be:
- Profits.
- Derived from a transaction entered into by the taxpayer with the intention or purpose of making a gain.[21]

(c) Where such gains arise by the disposition of an asset the relevant profitmaking intent must exist at the time the asset was originally acquired.[22]

(d) The profitmaking intent:
- Need not be the sole or even the dominant intent.[23]
- Will not of itself suffice to convert a gain into income if the taxpayer is not otherwise engaged in carrying on business.[24]

The approach of the Full Court to date has been to emphasise that each case will still turn on its own facts but the facts which may suffice to characterise a receipt as income, at least where the taxpayer is carrying on a business, are now somewhat wider than was originally the case. No doubt taxpayers in the future will be more cautious in framing their disclosure statements and giving evidence as to their actual intent. Certainly the cautious prospective tenant should in future consider the benefits of a rent holiday rather than a cash inducement.

Whilst it was not strictly necessary to do so, the Full Court in *Cooling's* case[25] also went on to express certain opinions as to the effect of s 160M(6) and (7) of the ITAA. These same questions were also ventilated in *Hepples v Federal Commissioner of Taxation*[26] which was decided by the same Full Court immediately after *Cooling's* case.[27]

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17 (1988) 88 ATC 4126, 4130.

18 See in this regard the paper delivered by FR Fisher QC to the 9th National Australian Legal Convention entitled *Changes in the Ordinary Concepts of Assessable Income*. It provides an interesting survey of these decisions.

19 (1987) 163 CLR 199.

20 *Federal Commissioner of Taxation v Myer Emporium Pty Ltd* (1987) 163 CLR 199. Note here the emphasis is on the word 'may'.

21 Ibid. Although one must query whether the gain must arise by the means originally intended as such a contention would appear to be contrary to earlier authority.

22 Ibid.

23 *Federal Commissioner of Taxation v Cooling* 90 ATC 4472.

24 *Thiel v Federal Commissioner of Taxation* 88 ATC 4094.

25 90 ATC 4472.

26 90 ATC 4497.

27 90 ATC 4472.

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In *Cooling*[28] the Full Court unanimously decided that s 160M(6) will only apply to property rights carved out of or over existing assets 'in circumstances where the asset affected by the rights created continues to exist'.[29] The only rights created between the taxpayer and the AMP Society in *Cooling's* case[30] were rights under the guarantee agreement. The section could not apply to those rights as they were not 'carved out of or over existing assets'. This is an important point as, prior to the decision in *Cooling's* case,[31] it had been widely feared that s 160M(6) could, on one interpretation, create bizarre results by taxing all transactions whereby rights were created. The circular manner in which the section was drafted was scathingly criticised by Hill J:

> . . . the former is drafted with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit sensible meaning from its terms.[32]

Essentially the court had to decide between two interpretations of the section. The first possible construction was that the section was intended to apply to tax the full value of all and any property rights which might be created by any action of a taxpayer. The other interpretation was that the section was only designed to tax the creation of property rights out of or over pre-existing assets. The court chose the latter interpretation as:

> An interpretation which confines s 160M(6) to a reasonable meaning, consistent with the object and policy of the legislation is, in my view, to be preferred to one which produces capricious results which seem inconsistent with the scheme of it.[33]

Whereas the court was unanimous in its interpretation of s 160M(6) this was not the case with s 160M(7). Hill J also sought to limit the effect of this section by confining its operation to situations where the 'asset' referred to in ss 160M(7)(a) is an asset owned by the taxpayer. His primary reasons for this were:

- The theme underlying Part IIIA is the taxation of gains arising from assets owned by the taxpayer and not gains arising from somebody else's assets.
- The adoption of any other interpretation would, when regard is had to the literal interpretation of the section, be conducive of absurdity.

The first proposition would appear correct if two conditions are met. First, there must be only two identifiable parties to the transaction.[34] For

28 Ibid.
29 *Federal Commissioner of Taxation v Cooling* 90 ATC 4472, 4475, per Gummow J. Similar sentiments were also expressed by each of Lockhart and Hill JJ in their reasons for judgment.
30 90 ATC 4472.
31 Ibid.
32 *Federal Commissioner of Taxation v Cooling* 90 ATC 4472, 4488.
33 Ibid 4490.
34 This is certainly the case with each of the examples referred to in the Treasurer's Explanatory Memorandum, for example: '. . . where a taxpayer receives or becomes entitled to receive an amount of money or other consideration for the forfeiture or surrender of a right or for refraining from exercising the right or receives consideration for the use or exploitation of an asset.'

example, in such two-party transactions the section contemplates that the money be received as consideration for an 'act transaction or event' performed in relation to a pre-existing 'asset'. It therefore follows that the person who pays the 'money or other consideration' is not the person who holds the pre-existing asset. If there are only two parties to the transaction then the pre-existing asset can only belong to the person who receives the consideration. Unfortunately this reasoning breaks down completely once one accepts the proposition that the section may apply to three-way transactions.[35] Second, the second use of the word 'asset' in the section must refer to an asset created out of or over the 'asset' first referred to. Unfortunately this reasoning also breaks down if the second use of the word 'asset' refers instead to a deemed asset which is entirely independent of the first asset. In contrast to Hill J, each of Lockhart and Gummow JJ found that it was not necessary that the 'asset' referred to in s 160M(7)(a) be owned by the person receiving the consideration. They further found that the second use of the word 'asset' in the section did refer to a deemed asset.[36] As a consequence they found that the inducement payment was caught by the section.

Hill J's second proposition is perhaps the stronger one. As His Honour pointed out in his reasons for judgement, if the 'asset' could be owned by someone other than the taxpayer, then the following absurd consequences would appear to follow:

- If a husband sold an asset but the wife received the purchase money, then both parties are potentially assessable. The husband would be assessed on any capital gain on the sale and the wife would be assessed on the whole consideration under s 160M(7).
- If a donee makes a gift by a cheque, then the delivery of the cheque is an 'event' which takes place in relation to an asset (namely the bank account) which entitles the donee to be paid the value of the cheque. What would prevent, in this instance, the application of s 160M(7) to tax the donee for the entire gift?

Unfortunately, the law now appears to be open to such absurdities as a consequence of the majority's decision in this case.[37]

It is indeed curious that the Full Court has resolved one area of uncertainty in relation to s 160M(6) only to replace it with one nearly as bad by its interpretation of s 160M(7). It is ironic that this has occurred

35 It was on this issue that Lockhart and Gummow JJ did not agree with Hill J, albeit implicitly. As a consequence the majority were able to find that s 160M(7) did apply to catch the inducement payment, even though the 'asset' (the building) was not owned by Mr Cooling.

36 The reasons of Lockhart and Gummow JJ on this issue are not contained in *Cooling's* case but were instead elaborated in *Hepples v Federal Commissioner of Taxation* 90 ATC 4497, which was decided by the same Full Court immediately after *Cooling's* case.

37 Similar arguments were raised by the counsel for the appellant in *Hepples v Federal Commissioner of Taxation* 90 ATC 4497. In that case, however, the emphasis was put on the possibility that the same taxpayer would, in some situations, be exposed to the possibility of double taxation. This notion was rejected by Gummow and Lockhart JJ on the basis that s 160ZA(4) would apply to prevent this occurrence. Whilst that might be the case, that section provides no protection to the examples referred to by Hill J in this paper.

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by a liberal interpretation of the latter and a restrictive interpretation of the former. Before this decision the conventional wisdom held that it was s 160M(6) and not (7) which would pose the major problem in practice. We can only hope that subsequent decisions of the Full Federal Court or the High Court will either limit or reverse the majority's approach in *Cooling* in relation to s 160M(7).

Postscript: An application by Mr Cooling for special leave to appeal to the High Court was dismissed on 16 November 1990, although special leave to appeal has been granted in *Hepple's* case.