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# The Meaning of Income : the Implications of *Stone v FCT*

## **Abstract**

In the recent case of *Stone v FCT*, the Australian Federal Court had difficulty in determining whether grant payments made to an elite athlete should be characterised as income. Both levels of the Court determined the character of the payment based on a whether or not Ms Stone was carrying on a business or merely pursuing a hobby. This article argues that the distinction between a business and hobby should not blur the interpretation of what constitutes income according to ordinary concepts. The suggested threshold of when voluntary payments received by an athlete will attain the character of income should be when the individual commences commercially exploiting their personal attributes for money.

## **Keywords**

income tax, Australian federal court, tax legislation

## THE MEANING OF INCOME: THE IMPLICATIONS OF *STONE V FCT*

*By Dr Braedon Clark\**

In the recent case of *Stone v FCT*, the Australian Federal Court had difficulty in determining whether grant payments made to an elite athlete should be characterised as income. Both levels of the Court determined the character of the payment based on a whether or not Ms Stone was carrying on a business or merely pursuing a hobby. This article argues that the distinction between a business and hobby should not blur the interpretation of what constitutes income according to ordinary concepts. The suggested threshold of when voluntary payments received by an athlete will attain the character of income should be when the individual commences commercially exploiting their personal attributes for money.

### Introduction

*Income tax, if I may be pardoned for saying so, is a tax on income.*<sup>1</sup>

Despite this simple statement, income is a difficult concept to define. Australian courts have long been troubled with the issue of what constitutes income. The problematic nature of the definition of income may be due to legislature not including all receipts in the definition of income in tax legislation. Exemptions and preferences will always cause problems in defining income.

Income in Australia includes income according to ordinary concepts and statutory income that is defined in tax legislation.<sup>2</sup> There are a number of other definitions of types of income found in Australia's tax legislation, for example, the definition of assessable income as distinct from taxable income in s 6 of the *Income Tax Assessment Act 1936* (Cth) ('ITAA'), yet in neither the 1936 nor 1997 tax legislation is there a comprehensive definition of income.

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1 *London County Council v Attorney-General* [1901] 4 TC 293 Lord Macnaughten, 293.

2 Section 6-1 *Income Tax Assessment Act 1997* (Cth). Section 6-5 states that 'income according to ordinary concepts' is ordinary income.

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Income according to ordinary concepts clearly includes income from employment, from running a business and from performing services. Receipts from a one-off prize, such as winning the lottery or a cash windfall from undertaking a hobby are ordinarily not considered as income.<sup>3</sup>

Many taxpayers have argued that their activities are not subject to tax as their receipts do not have the character of income. One of the most famous objectors, Al Capone, declared '[t]he income tax law is a lot of bunk. The government can't collect legal taxes from illegal money.'<sup>4</sup> Unfortunately for Mr Capone, and many other objectors, the scope of income is ever widening.<sup>5</sup> In *Scott v Commissioner of Taxation*,<sup>6</sup> Jordan CJ, of the New South Wales Supreme Court held:

The word 'income' is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind, except in so far as the statute states or indicates an intention that receipts which are not income in ordinary parlance are to be treated as income, or that special rules are to be applied for arriving at the taxable amount of such receipts.<sup>7</sup>

Contemporary objectors to the court's interpretation of income include Joanna Stone, the Australian Taxation Office ('ATO') and the Australian Olympic Committee ('AOC'). In the current case of *Stone v FCT*, the ATO has been granted leave to appeal to the High Court to decide an issue of paramount public importance.<sup>8</sup> This issue is whether or not the ordinary income of a policewoman includes funding and receipts generated from her participation and performance as a world class javelin competitor.<sup>9</sup>

3 See s 160 ZB(2) of the *ITAA 1936* (Cth) in regard to an exemption from capital gains tax for a lottery win.

4 <[http://www.archives.gov/exhibit\\_hall/american\\_originals/capone.html](http://www.archives.gov/exhibit_hall/american_originals/capone.html)> at 23 December 2004. Al Capone was charged with 22 counts of tax evasion totalling over \$200,000. He was found guilty and sentenced to 11 years imprisonment and \$80,000 in fines and court costs.

5 See *Commissioner of Taxation v La Rosa* [2003] FCAFC 125, para 5. Here the Full Federal Court held that 'income has been accepted as including the proceeds of criminal activities.'

6 (1935) 2 ATD 142.

7 *Ibid* 144-5.

8 *Commissioner of Taxation v Stone* [2004] HCA Transcript 219 (18 June 2004).

9 *Ibid* 2. Here Mr Pagone QC, counsel for the ATO, stated that 'this is a matter involving the question about the assessability as income under ordinary concepts of

### Stone v FCT

This case involves Ms Joanna Stone who, in addition to being employed full time as a senior constable in the Queensland Police Force, is one of Australia's leading javelin throwers. In her 1999 income year, Ms Stone disclosed assessable income of \$39,832 representing her salary from the Queensland Police Force. She further disclosed an amount of \$136,448 from her javelin throwing activities. This amount was not reported as assessable income and no claim was made for deductions relating to this activity.

The Commissioner assessed Ms Stone to income tax on the total of the amount and claimed that the receipts were assessable income derived from the carrying on of a business. This business is that of 'a professional athlete'.<sup>10</sup>

Ms Stone's total amount of \$136,448 included five different categories of payment:

1. prize money at local and international events: \$93,429;
2. grants from the AOC and the Queensland Academy of Sport ('QAS') of \$22,500 and \$5,400 respectively;
3. appearance fees of \$2,400;
4. sponsorships of \$12,400; and
5. an award of \$1,000 from Little Athletics Australia for being the 'role model of the year'.<sup>11</sup>

Ms Stone objected to this assessment by the Commissioner and the matter was first heard by Hill J in the Federal Court in 2002. At this hearing Ms Stone conceded that the sponsorship payments were assessable income and the Commissioner conceded that the Little Athletics payment was not assessable income.<sup>12</sup>

This left Hill J with the task of deciding whether the grants, prize money and appearance fees were income according to ordinary concepts.

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receipts be an elite sportsperson which were received by her in the course of that activity.'

10 *Stone v Commissioner of Taxation* [2003] FCAFC 145, para 70.

11 Ms Stone also received \$1,600 from the Oceania Amateur Athletics Association in this year.

12 Above n 10, para 5.

Hill J identifies the main problem in deciding this case in the first heading of his judgment, titled: 'The blurring of a distinction between professional and amateur sport.' Although this may be the predominant issue that will determine the character of payments received by Ms Stone, there are four primary legal issues in the case:

- 1 what is income according to ordinary concepts;
- 2 whether or not Ms Stone was carrying on a business or merely pursuing a hobby;
- 3 whether any of the payments received by Ms Stone were made as a reward for personal service; and
- 4 whether grants received by Ms Stone were paid as compensation for an income item.

### **Income according to ordinary concepts**

The meaning of the term ordinary income depends to some extent on the natural meaning of the words and also on the interpretation of such by the courts and academic writers.<sup>13</sup> In his judgment, Hill J, placed significant emphasis on the discussion of income in the work of Professor Parsons *Income Taxation in Australia* published in 1985.<sup>14</sup>

The three attributes of income listed by Hill J were:

- 1 That the amounts or some of them represent gains from a business (Proposition 14).
- 2 That the amounts or some of them represent reward for services rendered (Proposition 13).
- 3 That the amounts are a gain which is compensation for an item that would have had the character of income if it had been derived (Proposition 15).<sup>15</sup>

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13 It is beyond the scope of this article to discuss in detail the concept of income and the definition of income. If you would like to read further on this topic see Kevin Holmes, *The Concept of Income* (2002) IBFD.

14 RW Parsons, *Income Taxation in Australia* (1985) Law Book Company Limited.

15 *Stone v Commissioner of Taxation* [2002] FCA 1492, para 60.

In addition to these factors there are a number of other common law attributes that have been recognised as assisting in the determination of what is income. These are:

- 1 is the receipt earned? (does it accrue by virtue of office or employment?)
- 2 is it received periodically or in a recurring manner?
- 3 does it come from the use of an asset?
- 4 is it compensation for loss of income?
- 5 is an item convertible into money?<sup>16</sup>

In determining whether a payment is income, the courts have established the following three principles. First, whether a payment ought to be treated as income must be determined in accordance with the ordinary concepts and usages of mankind.<sup>17</sup> Second, whether the payment received is income will depend on a close examination of the specific facts and by looking at the character of the payment in the hands of the recipient.<sup>18</sup> Third, the test to determine the character of a payment must be made objectively.<sup>19</sup>

Hill J places little focus on the concept of income and the Full Federal Court did not discuss the concept at all in reaching its decision in the *Stone* case. At both levels of the Federal Court, emphasis was placed on examining the facts of Ms Stone's javelin career to determine if her activities went beyond the mere pursuit of a hobby to a level where Ms Stone was carrying on the business of a professional athlete.

ATO Tax Ruling 1999/17 deals specifically with the taxation of receipts and other benefits received by sportspeople in Australia. In this ruling the ATO make a number of general statements regarding the character of payments received by athletes. These statements are all closely linked to the historical characteristics of carrying on a business, and case law on determining when a voluntary payment may be characterised as assessable ordinary income. It seems that both the ATO and the Federal Court feel constrained by these historical attributes of what constitutes the carrying on of a business and the income nature of a voluntary payment. This constraint results in difficult and obscure reasoning in the tax ruling

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16 From *Tenant v Smith* (1892) 3 TC 158 and *FCT v Cooke and Sheridan* (1980) 42 FLR 403.

17 ATO TR 1999/17, para 16.

18 *Ibid* and above n 15, para 59.

19 *Ibid*.

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and the judgments in *Stone's* case. This case represents a new industry, the industry of sport and it may be that the old attributes of what constitutes carrying on a business are not easy or relevant to apply to the business of being a professional athlete. As Kirby J stated in the High Court leave to appeal proceedings in this case; the concept of ordinary income should be what the ordinary person in the street would consider to be income of a sportsperson such as Ms Stone.<sup>20</sup>

The High Court should not hesitate in recognising that the existing propositions of what constitutes income and the indicative criteria to determine the carrying on of a business do not replace the primary test of income according to ordinary concepts. If you ask a person on the street whether the different payments received by Ms Stone are income or not, they will not consider a list of factors such as that listed above in determining if these payments are taxable. A person will simply consider wider criteria such as whether Ms Stone is commercially exploiting her skills.

The ATO allude to a commercial exploitation test for determining the income of an athlete in paragraph 26 of TR 1999/17. Here the ruling states that:

A business of participating in sport includes:

- the commercial exploitation of skills developed as a pastime or hobby; and
- the commercial exploitation of skills developed and used in the pursuit of sporting excellence.

Both situations above will result in sport becoming a taxpayer's vocation or calling and therefore a business (see definition of 'business' in section 995-1 of the ITAA 1997). A sportsperson's business could also involve the commercial exploitation of his or her 'public fame' or 'image'. Typically, commercial exploitation will involve an individual utilising his or her skills in a systematic, regular and/or organised manner with a view to obtaining assessable income. This is despite the fact that many of the usual indicators of a business are absent ... A sportsperson will not be carrying on a business in respect of his or her sporting activities merely because he or she is utilising his

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20 Above n 8, 3:

[I]f you went out there on the street and said to ordinary Australians, 'Is the money that a sportsperson gets as a prize income for the purposes of taxation' the ordinary Australian would say. 'No, it is a prize'. Now the question in this case is whether given her brochure, her promotion of herself, the regularity of the flow, it has taken on a different quality... and That is what Sir Owen Dixon set as the test – ordinary notions of the concept of income.

or her skills in a systematic, regular and organised manner unless he or she is doing so for the purpose of commercially exploiting those skills.<sup>21</sup>

As the ATO recognise, an individual may be in the business of being a professional athlete, even when some of the usual indicia of being in business are not present. Similarly, an athlete that undertakes training and competition in a systematic and organised fashion may similarly receive payments that are not considered as income according to ordinary concepts as there may be no commercial exploitation of the skills developed in pursuing their hobby.

It is a difficult determination to make; however both the single judge and Full Court of the Federal Court emphasised whether Ms Stone had turned her talent to account for money.<sup>22</sup> Hill J held that the circumstances in *Stone's* case suggested that Ms Stone was in the business of turning her talent for money, whereas the Full Federal Court held the opposite. The Full Court recognised that Ms Stone had pursued sponsorship and had authorised others to attempt to generate financial support for her to pursue her javelin throwing. However, the Full Court held this pursuit of sponsorship was not a 'systematic application of her talents as a sportswoman for the commercial objectives of her sponsors.'<sup>23</sup> In the opinion of the Full Court, Ms Stone was not in the business of turning her talent for money.<sup>24</sup> The decisions of Hill J and the Full Federal Court have been constrained by the legal distinction between a business and a hobby. It may be more appropriate for the Court to recognise that, as soon as the individual seeks to commercially exploit their skill then any income arising from this pursuit should be characterised as income according to ordinary concepts. Moreover, any costs that have been incurred by the taxpayer in the pursuit of this exploitation should be allowable deductions according to s 8-1 of the *ITAA 1997*.

It is difficult to establish a normative threshold of when a person ceases to pursue a hobby and commences carrying on a business. This difficulty is exacerbated when looking at artists, athletes and authors who receive payments based on their personal attributes. Their activities may not be carried on with a profit motive and indeed, even when they are commercially exploiting their skills, this often does not result in a profit. The point of balance is arguably commercial exploitation. An athlete, author or artist who is not seeking to commercially exploit their skill may

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21 TR 1999/17, para 26.

22 Above n 10, para 70.

23 Ibid para 87.

24 Ibid para 92.

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fall on the side of a hobby. Whereas those who have turned their talent for money may fall on the side of a business.

As suggested above, the activities of the individual may not be objectively perceived to be a business, yet if they are commercially exploiting their skills then receipts that are incidental or directly related to these skills should be considered to have the character of income.

Therefore, in the *Stone* case, Ms Stone had engaged a manager, sought out and received sponsorship indicating a commercial exploitation of her talent for throwing javelins. Ms Stone's position should be distinguished from those athletes that have not actively sought money from their talent. As TR 1999/17 states, it is important to consider the intentions of the athlete in conducting their affairs.<sup>25</sup> As a consequence, an amateur athlete that merely receives a voluntary sponsorship payment from a local apparel company and a grant from the AOC would most likely not be considered as commercially exploiting their personal attributes. Therefore, a voluntary receipt should not be characterised as income in their hands.

The courts have established a number of principles that support the above proposition. First, in *Moorehouse v Dooland*<sup>26</sup> the court held that 'payments given by reason of the recipient's "personal qualities" are unlikely to be taxed.'<sup>27</sup> Second, in *Brajkovich v Federal Commissioner of Taxation*<sup>28</sup> the court held that emphasis should be placed on considering 'whether the ... activity in question is of a kind which is ordinarily thought of as a hobby or pastime.'<sup>29</sup>

In *Stone's* case, Ms Stone has received an AOC grant due to her personal attributes. However, the way she has pursued the hobby may now no longer be considered to be a hobby by the ordinary person on the street. As is evident from the facts of the *Stone* case, the pursuit of funds and sponsorship by Ms Stone's family and representatives was carried out in a sporadic and impromptu fashion.<sup>30</sup> However, as the Supreme Court of New Zealand held in *Grieve v Commissioner of Inland Revenue*,<sup>31</sup> '[b]usinesses do not cease to be businesses because they are carried out

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25 TR 1999/17, paras 29 and 33.

26 [1955] 1 Ch 284.

27 Ibid 303-304.

28 20 ATR 1570.

29 Ibid para 35.

30 Above n 15, para 73-89.

31 (1984) 1 NZLR 101.

idiosyncratically or inefficiently or unprofitably, or because the taxpayer derives personal satisfaction from the venture.<sup>32</sup>

Even if Ms Stone's activities are perceived as a hobby (the throwing of javelins) by the ordinary person on the street, payments arising from the commercial exploitation of her skill may still be considered as income, according to the same ordinary person. The argument flows for authors and artists in a similar way. If a new author enjoys writing and is not intending to sell their work, then a voluntary grant from the government should not normally have the character of income. However, once the author or artist commences selling their work for money or seeking funds from people who wish to advertise or promote their works then voluntary payments received from the government or other sources will arguably change character and become incidental to their income producing activity. This will be the result, whether or not the activities are carried on for the purpose of profit or in a systematic and organised manner.

### **An alternative proposal**

The Federal Court in *Stone* has been constrained in its interpretation of income by the distinction between carrying on a business and pursuing a hobby. The suggestion made above is that the Court should not let this distinction restrict its interpretation of income according to ordinary concepts. The distinction between a business and commercial exploitation of a personal attribute is that commercial exploitation lacks a number of the objective criteria used to define a business.

Commercial exploitation of a skill or attribute may not actually be a category of income that falls between a business and a hobby, but rather, is incorporated in an existing form of income. That is income from personal exertion or income derived from personal exertion. Income from personal exertion is defined in s 6 of ITAA 1936 as 'income consisting of earnings, salaries, wages, commissions, fees, bonuses, pensions ... allowances and gratuities received in ... relation to any services rendered...'. This article suggests that the majority of payments received by Ms Stone should rightly be characterised as income from personal exertion. Whether the payments represent an indirect form of service, such as sponsorship payments, or direct payments for service, such as speaking at a sports function, they should be characterised as income from personal exertion. The payments that do not fall clearly within this category are voluntary payments such as the AOC grants.

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32 Ibid 110.

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This article proposes that to determine the character of a voluntary payment as income or not, a purposive test, similar to that set out in s 8-1 of ITAA 1997 should be used.<sup>33</sup> Section 8-1 of ITAA 1997 is the general deductions section that details when a loss or outgoing of a taxpayer is deductible from their assessable income. A taxpayer may deduct an outgoing when it has been incurred for the purpose of producing their assessable income. This article suggests that a corresponding purposive based test could be beneficially applied to determine whether a payment has the character of income.

For example, if you consider the AOC grants received by Ms Stone. If it could be objectively assessed that the purpose of Ms Stone's activities was to generate a gain, then any direct or incidental gain that arises from that activity should have the character of income. The proposed test could read as follows: 'A gain is income if your activity had the purpose of making a gain'. This test provides for two results when assessing the character of a voluntary payment. First, in a situation where the facts of an individual's activity suggest that there was no purpose to generate a gain, any voluntary payments received would not have the character of income. Second, where the facts of the individual's activity objectively suggest that the purpose of the activity was to generate a gain, then voluntary payments should have the character of income.

The assessment of an individual's purpose needs to be assessed objectively on a case by case basis. However, this test allows an element of flexibility when determining the character of a gain that is not income from business or income that arises from personal exertion.

#### **Payment for services**

At both levels of the Federal Court, the Commissioner of Taxation raised the argument that the AOC grant payments may be payments for services rendered by Ms Stone. However, in both decisions the court held that the payments were not a product or incident of any employment or services and that 'the amounts were paid to athletes precisely because they were elite athletes whom it was hoped would, with encouragement, ultimately form part of the Australian Olympic Team and procure medals for Australia.'<sup>34</sup>

#### **Payment in lieu of income**

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33 I would like to acknowledge that this suggestion is based on the argument of Professor Jim Corkery, Bond University.

34 Above n 15, para 96.

At first instance, counsel for the Commissioner of Taxation argued that the AOC grants received by Ms Stone may be considered as assessable income as they were payment in lieu of income. The argument was based on the High Court decision in *FCT v Dixon*.<sup>35</sup> In this case a payment was made to a former employee by an employer to make up the difference between the employee's salary and the amount they would receive in military pay after enlisting to serve in the Australian military in the Second World War. The High Court held that 'an expected periodical payment ... [which] formed part of the receipts upon which he depended for the regular expenditure upon himself and his dependants and was paid to him for that purpose'<sup>36</sup> had the character of ordinary income.

This article suggests that Hill J misapplied this case to the facts in *Stone* and that, even where this decision is directly applicable, it is a marginal judgement that is strongly influenced by the relationship between an employee and employer.<sup>37</sup> In *Dixon* the majority of the High Court held that there were four elements that a payment should satisfy for it to be characterised as a payment in lieu of income. These are:

- 1 that the payment is expected;
- 2 that the payment is periodical;
- 3 that the payment formed part of the regular receipts of the recipient, that the recipient depended on for normal expenditure; and
- 4 the payment was made for the purpose of supplementing the missing receipts.<sup>38</sup>

The AOC grants received by Ms Stone were made on a periodic basis and it is arguable that they were expected by Ms Stone, due to her position as one of Australia's leading athletes. However, the payments did not form a part of her normal police salary and the purpose of the AOC was not to replace any decrease in salary. In the decision at first instance, Hill J held that the AOC payments made to Ms Stone were payments in lieu of income and relied heavily on the express purpose of the Olympic Athlete Program grant which was to assist athletes with

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35 (1952) 86 CLR 540.

36 *Ibid*, Dixon and Williams JJ, 557.

37 The decision was 3:2, with the joint judgment of Dixon CJ and Wilson J strongly focused on the employee/employer relationship and that there was a clearly identifiable salary amount that was being replaced by the payment.

38 Above n 32, para 6.

living expenses.<sup>39</sup> Hill J held that the periodic nature of the payments and the intention of the AOC to assist athletes with their normal expenditure, tilted the balance toward the payment having the character of income.<sup>40</sup>

The better view is to see this payment as having a solely patriotic purpose to assist Australian athletes with their training and travel costs and to promote the nation. Further, the decision of the High Court in *Dixon* should be narrowly applied. In determining whether a payment is in lieu of income it does not seem relevant to consider how the payment is actually spent in the hands of the recipient. Of relevance is the character of the payment that it is in lieu of. In regard to an athlete or artist or author receiving a grant from the government it is difficult to identify a payment that this grant is replacing and is most commonly a supplement to ordinary income rather than a payment in lieu.

### Summary

Tax practitioners in Australia will welcome a clear decision from the High Court on the interpretation of the concept of ordinary income. It will be interesting to see if the High Court will feel constrained in a similar way to the Federal Court to classify Ms Stone's activities as either a business or a hobby in justifying its determination on the character of payments received by her. The most progressive approach should be to recognise that the payments received by Ms Stone are income even if the ordinary person on the street would not consider her to be conducting a business. Surely if an individual is commercially exploiting a skill or image, then no matter how poorly they pursue this task, any payments received from this pursuit or incidental thereto have the character of income according to ordinary concepts.

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39 Above n 15, para 115.

40 Ibid.