What Constitutes Income

There is no single concept of what constitutes income. It is not defined explicitly in the Income Tax Act. In practice, the meaning of income is largely determined with reference to decided cases (common law) in order to distinguish between income and capital gain as the former is taxable and the latter is not.

According to Lord MacMillan in *Van Den Berghs v Clark (1935)*, "The Income Tax Acts nowhere define income any more than they define capital. So, it is to the decided cases that we must go in search of the light. Whilst each case is found to turn upon its own facts, no infallible criterion had emerged.

In *CIT v IA (2006)*, Justice Andrew Phang in the Court of Appeal observed "it is a notorious and unfortunate fact that the distinction between the concept of capital and that of revenue is often elusive and even illusory. Even on the most promising of occasions, there are tremendous difficulties of application…"

This article aims to provide some guidance on this area of complexity in tax. Although no infallible criterion has emerged from the decided cases, the following tests may be applied as a guide:

1. Permanent structure versus subject matter of the business

Profits derived from the realisation of assets forming part of the permanent structure of a business would be regarded as capital in nature while those relating to transactions in the course of a business are liable to be taxed.

2. Fixed or circulating capital

According to Lord Haldane in *John Smith & Son v Moore (1921),* "Adam Smith in his book *Wealth of Nations* described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes a profit of by parting with it and letting it change masters. This classic distinction has since been widely used; economists have never been able to define such more precisely what the line of demarcation is." Receipts from the disposal of fixed capital would accordingly be capital in nature and receipts from the disposal of circulating capital would be revenue in nature.

Lord Hanworth M.R in *The European Investment Trust Co. Ltd v Jackson (1932)* remarked, "The question whether or not a sum is fixed or circulating capital is one of degree and therefore a question of fact."

In practice, to decide whether a disputed item falls under taxable income or capital gain, a close examination of the nature of the trade, the relation of the asset to the ordinary trading operations and the purpose and the circumstances in which the item was acquired and subsequently sold is necessary.

In *F Housing Sdn Bhd v DCIG (1976)*, the issue was whether compensation received for land acquired by the government is taxable income or capital gain when it was a single transaction. The Court said, “It is necessary first to decide whether the land in question is stock-in-trade or capital” and upheld that the land was stock-in-trade and the compensation payment was income and thus taxable.

3. The test of intention

Possibly the important test laid down by the Courts is the “purpose test” for which the asset was originally acquired. If an asset is acquired for resale with a view to profit, the proceed from the sale of such asset is generally revenue in nature. Conversely, if an asset is acquired with the object of deriving an income from it and not for resale at a profit, the proceed from the sale of the asset is generally considered capital in nature.

The application of this test involves considering all the facts and circumstances surrounding the acquisition and the method of dealing with the asset.

Justice Andrew Phang explained in *CIT v IA (2006)* that the “purpose test” provides an eminently appropriate starting-point for any inquiry of this nature. Simply put, did the taxpayer intend to enter into a transaction having the character of revenue or did it, instead intend to enter into a transaction having the character of capital? The purpose of the transaction must be considered in the light of the objective facts and not the subjective intentions of the taxpayer.”

In addition, Sharma J also stated in *NYF Realty Sdn Bhd v CIR (1974)* “The focal point of enquiry is the dominant purpose for which the particular property was originally acquired. If it is established that the dominant purpose was its resale at a profit, the presence of other purposes, such as the rental of that property does not remove any profit on ultimate sale from the taxable area.”

In *COT v Levy (1952)*, “It is not essential that the intention must be clearly antecedent to, or present at, the time of acquisition. If at the date of purchase there was no clear intention, then in order to decide the issue it is necessary in principle and for practical reasons, to seek the main or dominant factor operating to induce the taxpayer to make the acquisition. In such circumstances the question is essentially a matter of degree.”

In *CIR v Lydenburg Platinum Ltd (1929)*, “A taxpayer may change his intention in regard to the use of the asset. If the original intention was to work it to derive income, but subsequently the owner changes his intention and the land thereafter became stock-in-trade in the general profit-making scheme of dealing in land, then any profit derived from the sale of such land would be of an income nature as the owner had changed his intention, and vice-versa.”

4. Period of holding

In *Reliance Land Investment Co (Pty) Ltd v CIR 1946 WLD (1971)*, it was held that, “recurrence of a receipt or the length of time for which an asset is held is not necessarily a decisive test as to whether it is capital or income though it is an important element to be taken into consideration.” A profit derived after a long holding period may suggest that the asset was held as a long-term investment whereas an asset disposed of shortly after acquisition may prima facie be regarded as an asset purchased for resale in the short term for a profit. This may not necessarily be the case and it must be considered in conjunction with all other factors.

In *Turner v Last (1966)*, Gross J observed "A person may buy something for his own use with no idea of a quick resale, and then, quite unexpectedly he may receive an offer to buy which is too tempting to refuse…but the fact that there was a quick resale naturally leads one to scrutinize the evidence that it was not envisaged from the first… If the sale was contemplated at the time of purchase, it will very difficult to resist a finding that a trade has been carried on…"

5. Frequency of similar transactions

If any particular transaction is found to be one of a series and there is evidence of habitual and continuous activity, then the transaction may fall into the general pattern which as a whole constitutes a trade. On the other hand, it may be argued that a number of desultory transactions over a number of years do not constitute a trade.

The test of frequency must be considered in relation to the subject matter as Rowlatt J stated in *Pickford v Quirke (1927)* "It is very well know that one transaction of buying and selling does not make a man a trader, but if it is repeated and becomes systematic, then he becomes a trader and the profits of the transaction, not taxable so long as they remain isolated, become taxable as items in a trade as a whole…"

6. Supplementary work made to property to render it more saleable

In *IRC v Livingstone (1926)*, the fact that material alterations were made to a cargo vessel to improve its character and to make it more marketable was significant in indicating a trading transaction, because there was an organised effort to obtain profit. But Lord Sands remarked that this test is not, however, decisive by itself.

7. Circumstances which were responsible for the sale

In *West v Phillips (1958),* "If an asset is sold because of some unanticipated factors or a sudden need for ready money, such causative circumstances would indicate a presumption that the asset was not originally acquired for trading purposes**."**

8. Existence of a profit-seeking motive

In *Iswera v Ceylon CIT (1965)* Lord Reid upheld "Where direct evidence is absent or lacking, motive can sometimes be inferred from the surrounding circumstances of the transaction…if his acts are equivocal, his purpose or object may be a very material factor when weighing the total effect of all the circumstances."

However, the presence of a desire to make a profit is not conclusive either as Lord Buckmaster observed in Leeming v Jones "an accretion to capital does not become income because the original capital was invested in the hope and expectation that it would rise in value…".

9. The manner in which a disposal is secured

In *Martin v Lowry (1927)* (dealings in linen), it was held that if special effort was made to find or attract purchasers (sales campaign by extensive advertising) or a business organisation was used to effect the sale, then there is a presumption of trade."

10. Methods of financing

If the financing is from external borrowed funds, the obligation of having to repay the loan facilities periodically would point to the presumption of trade, for example, the need to realise income so as to repay the loan.

Applying any one of the above factors is not by itself conclusive. One has to consider all the circumstances and facts of each particular case. Nonetheless, the following five basic propositions could be said to have emerged from the decisions of the Courts:

a. Payments received for the sale of fixed assets of a business are prima facie capital

However, where the terms of sale of a capital asset contain a collateral trading bargain and receipts under such bargain may be taxable, for example, entitlement to some commission on the future sales.

Orchard Wine & Supply Co v Laynes (1952)
Lamport & Hold LineLtd v Langwell (1958) (shipowners / purchases of oil)
British Dyestuffs Corpn (Blackley) Ltd v IRC (1924)

b. Payments received for the destruction of the profit-making apparatus of a business are generally capital

H A Roberts Ltd v MNR (1969) "Receipt of compensation for the termination of some beneficial contract is generally treated as capital if the contract is in substance the very basis of the recipient's profit-making apparatus.

When the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the profit-making apparatus involving the serious dislocation of the normal commercial organization and resulting perhaps in the cutting down of the staff previously required."

Van Den Berghs Ltd v Clark 19 T.C 390 (1935) is the leading case where the rights and advantages surrendered on cancellation were held to destroy the whole structure of the profit-making apparatus.

Barr, Crombie Co Ltd v IRC (1945), "A firm of ship managers who only managed the ships of one shipping company received compensation when that company went into liquidation was held a capital payment."

In essence, a payment in consideration for the cancellation of a commercial contract will only be treated as capital if: –

(i) The cancellation destroys or materially cripples the whole structure of the profit-making apparatus; or

(ii) The contract cancelled was the only one or substantially the only one of its kind entered into.

Where the contract cancelled is just one of several such contracts, any payment for its termination is generally treated as an income receipt.

IRC v Fleming & Co (Machinery) Ltd (1961)
Californian Oil Products Ltd (in Liquidation) v FCT (1934) (agency agreement)

Exchequer Court in Parsons-Steiner Ltd v MNR (1962) (agency contract)

c. Payments in lieu of trading receipts are generally revenue

London and Thames Haven Oil v Attwool (1966), "Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising from the trade carried on by him, the compensation is to be treated for income tax purposes in the same way as that sum would have been received instead of the compensation."

Examples are:

(i) Obligation under contract-insurance recovery

J Gliksten & Son Ltd v Green (1929)
Keir & Cawder Ltd v CIR (1958) (insurance recoveries received for the loss of trading stocks were held to be trading receipts)
IRC v Williams Executors (1944) (compensation received for loss of profits was held to be revenue)

(ii) Compensation received for non-performance of a business contract would be revenue

This was reflected in *Short Bros Ltd v CIR (1927)* where a shipbuilding company was contracted to build two steamers. It agreed to cancel the contracts in return for a compensation payment. The Court of Appeal held that the compensation payment was a trading receipt received in the ordinary course of business.

In *Burmah Steam Ship Co Ltd v CIR (1930)* damages received for late delivery for overhaul repairs were held to be trading receipts.

In contrast, in *Kelsall Parsons & Co Ltd v CIR (1938)*, a firm entered into agency agreements for sale on a commission of the products of various manufacturers, varying from 2 to 14. In May 1934, an agency agreement was terminated, the Court of Session remarked, "Each case depends on its own facts. The Appellant's business is entirely different from the business carried on by someone who, under contract, acts exclusively as agent for a single principal. It was a normal incident of business that the contracts might be modified or discharged from time to time. The Appellants were not parting with something which could be described as an enduring asset of the business."

(iii) Damages for tort

Compensation for loss of trading profits resulting from a tortious act committed against the recipient will be treated as trading receipts as reflected in *London and Thames Haven Oil Co v Attwooll (1967)*.

(iv) Statutory payments

Governmental subsidy or grant hinges on the main purpose for which it was granted. If it was intended to assist the trader to perform his trading operations more profitably, the subsidy or grant will be considered a trading receipt.

These were reflected in the cases of Pretoria- Petersburg Ry Co Elood (1908), Charles Brown Co v IRC (1930) and Smart v Lincolnshire Sugar Co (1937).

d. Payments in return for the imposition of substantial restrictions on the activities of a trader are generally capital

(i) Sterilisation of assets

In *Glenboig Union Fireclay Co Ltd v CIR (1922)*, compensation received for refraining from working on the fireclay beds from the railway company was held to be capital in nature and thus not taxable.

(ii) Restrictive covenants

In *Murray v I.C.I. Ltd (1967)*, for certain "keep-out" covenants not to manufacture or sell Terylene in some European countries, lump sums payments received were held to be capital (Russell L.J stated that in substance the taxpayer disposed of a part of its fixed capital).

e. Payments of a recurrent nature are more likely to be revenue

<u>Know-how</u>

Whether an amount derived from the sale of know-how is capital or revenue depends on the facts and circumstances of each case:

(i) Whether the property in the know-how has been parted with or whether the value of the know-how has been substantially diminished as a result of the communication to another person; or

(ii) Whether the communication of the know-how is merely a way of deriving profit from the use of technical knowledge and experience (royalty) and that the recipient of the consideration retains ownership of the asset.

In *Rolls-Royce Ltd v Jeffrey (1962)*, payments received for the parting of the property are capital while those received for the use of technical knowledge and experience are of an income nature.

Evans Medical Supplies v Moriarty (1957), the House of Lords in reversing the decision of the Court of Appeal held, "Its possession had secured for the company a substantial share of the Burmese market; its loss will mean that its Burmese agency will become progressively less important, in other words, the company has parted with an asset which was the source of its profits. The company has parted with its property. I mean…a capital asset."

However, if a company is also carrying on a business of dealing in know-how, consideration received from the parting of the know-how in the course of that business would be of a revenue nature. That was how the Evans Medical case was distinguished by the House of Lords in the Rolls-Royce case where engineering "know-how" was sold under a series of agreements to different countries on a deliberate policy of licensing companies in other countries to manufacture its engine on terms involving payments of capital sums and royalties. The House of Lords held that the lump sums were trading receipts.

Similarly, in *English Electric Co Ltd v Musker (1964)*, it was held that the lump sums received for the sales of know-how were revenue receipts. Lord Radcliffe said: “The appellant had after the transaction what it had before it… But imparting know-how for reward is not like this, any more than a teacher sells his knowledge or skill to his pupil. The nature of receipts from it depends essentially upon the transaction out of which they arise, and the context in which they are received. The mere parting of know-how cannot be equated with the disposal of a capital asset.”

On the other hand, in *Wolf Electric Tools Ltd v Wilson (1968)*, the appellant company, trading in electric power tools in India, agreed to provide an Indian company with all present and future drawings, designs and technical knowledge for establishing a factory for the production of certain ranges of portable electric tools. It also assigned all its Indian patents to that company. The Court held that the shares issued by the Indian company to it as consideration for giving up its business in India is capital in nature.

Patent royalties

In *Constantinesco v. Rex (1927)*, the British government had made use of an invention during the First World War. The inventor was paid a sum of 70,000 pounds which the Court held was an income receipt.

The position was reinforced in *Lord Greene MR in Rustproof Metal Window Co Ltd v IRC (1947)* where a non-exclusive licence granted for the manufacture of a limited number of articles in return for a capital sum and a royalty was held that both the capital sum and the royalty of 3 pence per article were income payments.

In *Nethersole v Withers (1948)* Lord Greene MR said, “If the lump sum is arrived at by reference to some anticipated quantum of user it will normally be income. If it is not, and there is nothing else in the case which points to an income character, it must be regarded as capital.”

However, in the following cases, sums paid for the use of patent have been held to be capital:

In *Desoutter Brothers Ltd v Hangar & Co (1936*), a licence was granted for the use of a patent in consideration of a payment by installments of a total sum of 3,000 pounds which was not related to any particular quantity of production under the licence. It was upheld that the payment was capital in nature even though the grant was for a period of five years. The grantor was regarded as having disposed of a portion of the property in the invention and the important factors that the fixed sum stood as the price of the grant and that the payment was for future, not past user”

In *IRC v British Salmson Aero Engines Ltd (1938)*, an exclusive licence for ten years was granted for the manufacture of an aeroplane engine made by a French company. The consideration was the sum of 25,000 pound payable in three installments and a royalty of 2,500 pounds yearly over the next ten years. The Court of Appeal held the lump sum were capital but that the royalty constituted income.

Lump sums received for an outright sale of patent rights were held to be capital in *Handley Page v Butterworth (1935)*. Romer L.J remarked “If the patentee sells the monopoly or surrenders his monopoly in consideration of a payment, the payment would be capital.”

In summary, in determining the liability to income tax in Singapore, it is necessary to draw a distinction between taxable income and non-taxable capital gains. This is not always an easy task. Applying the above factors will help to draw out the relevant facts and circumstances under which the receipt arose and enable a holistic picture to emerge as to the nature of the receipt so as to determine if the receipt is revenue or capital in nature.

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