



Tax Insights

Full Federal Court overturns decision in Eichmann

Snapshot

On 18 September 2020, the Full Federal Court in [Eichmann v Commissioner of Taxation \[2020\] FCAFC 155](#) overturned the decision at first instance of the Federal Court. The Full Federal Court ruled in favour of the taxpayer, in concluding that an asset (a block of land) was used in the course of carrying on of the taxpayer's business so as to qualify as an active asset.

The issues before the Full Federal Court concerned whether the active asset test in section 152-40(1)(a) of the *Income Tax Assessment Act 1997 (ITAA 97)* had been correctly applied, and whether the taxpayer's property was an **active asset** based upon the facts and circumstances.

The matter arose in the context of the small business concessions in Division 152 of *ITAA 1997*, but the same issue is also relevant to the CGT participation exemption in Subdivision 768-G of *ITAA 97*.

Background and facts

In December 2016, the taxpayer sought a private ruling from the Commissioner in relation to the "active asset" question. In March 2017, the Commissioner ruled unfavourably. The taxpayer objected to the private ruling decision and the Commissioner affirmed the position under the ruling.

In February 2019, the AAT held in favour of the taxpayer, concluding that "the decision under review is set aside and substituted with a decision that the land is an 'active asset' for the purposes of section 152-40(1) ITAA." The Commissioner appealed against the AAT decision. The Federal Court decision of December 2019 found in favour of the ATO.

The relevant facts before the Full Federal Court were based on those contained in the ruling request. In broad terms, the facts were that the taxpayers disposed of a block of land and argued that the land was relevantly an active asset, in connection with a business of building, bricklaying and paving. The land had two sheds as well as a fence and security gate. The usage of the land involved the following:

- The sheds were used for storage of work tools, equipment and materials used in the business;
- The open space on the property was used to store material that did not need to be stored under cover, including bricks, blocks, pavers, mixers, wheelbarrows, drums, scaffolding and iron;
- Work vehicles and trailers were parked on the property;
- Tools and items were collected on an at least a daily basis; and
- Some preparatory work was done at the property, although the property was mainly for storage with the building, bricklaying and paving done on site.

The Federal Court at first instance (Derrington J) had taken a narrow view in interpreting the active asset test, and held that the usage of the land as outlined above was insufficient for the asset to be used in the carrying on of the taxpayer's business and was therefore not an active asset.

The decision of Derrington J significantly lifted the threshold for an asset to be relevantly taken used in the course of carrying on the business, such as requiring:

- "a **direct relationship** between the use to which the asset is put and the carrying on of the business";
- that the asset "must be used in the **ordinary and common flow** of the business transactions";
- a "**direct functional relevance** to the carrying on of the normal day-to-day activities of the business which are directed to the **gaining or production of assessable income**";
- that "the use must be a constituent part or component of the **day to day** business activities"; and
- activities which are in the course of carrying on the business are "those directed to the securing and performing" the construction, bricklaying and paving services.

Derrington J also noted that the use of the property for the storage of materials was not an activity in the ordinary course of taxpayer's business, and was instead "preparatory" in nature. Therefore, the Court held at first instance that the asset was not relevantly used in the course of carrying on a business, and was not an active asset. Our Tax Insights on the Federal Court judgment is available [here](#).

Submissions on appeal

Taxpayer's submissions

The taxpayer's submissions were essentially that Derrington J had put an "unwarranted gloss on the language of the statute", in finding that there was a necessary dichotomy between the use of an asset which is "preparatory" to the carrying on of a business and a use which is of direct functional relevance to that business.

They argued that the statutory language found in section 152-40(1) did not support these qualifications to the statutory test. The statutory test simply required a judgment to be formed as to whether an asset had been **used in the course of carrying on a given business**; this being a question of fact and degree in every case.

The taxpayer also argued that even if a "direct functional relevance" test is applicable under section 152-40, that the use of the property to store the work tools, equipment and materials of the business, which were collected from that property on a regular basis and taken to building sites satisfied that test.

Commissioner's submissions

The Commissioner strongly supported the decision and reasonings given by Derrington J in concluding that a direct functional connection was required between the "use" and the "course of carrying on a business". In essence, the Commissioner argued that in order to satisfy the active asset test, the use of the asset must be an integral part of the relevant business, and part of the process by which the business was carried on.

The Commissioner also submitted that:

- the ruled facts were inadequate in finding that the use of the land had sufficient connection with the taxpayer's business. For example, the facts did not state that the materials were stored for the purposes of the business or that they were going to be used at external sites. Therefore, at best, a finding could be made that the uses were **in relation to** that business but **not that they were in the course of** carrying on that business";
- the use of the term "active asset" was relevant to the construction of words which define that term and that it informed the constructional choices that needed to be made; and
- the use of the phrase "inherently connected with a business" as used in section 152-40(1)(b) in respect of intangible assets, supported a need for a "very close connection" in section 152-140 (1)(a).

Full Court Judgement

The decision of McKerracher, Steward and Stewart JJ of the Full Court addressed the two following issues:

- whether Derrington J had correctly identified the **applicable test** for the definition of an "active asset" in section 152-40(1)(a) of *ITAA 1997*; and
- if so, was the taxpayer's property nonetheless an **active asset** based upon the facts described in the private ruling.

Statutory interpretation of the "active asset" test

The Full Court concluded that based on the law and its extrinsic materials, the small business relief provisions in Div. 152 should be construed beneficially rather than restrictively, "in order to promote the purpose of the concessions conferred by that Division."

The Court deduced this purpose from the concessionary language used to describe the nature of the relief in Paragraphs 1.1 – 1.3 of the EM to the *New Business Tax System (Capital Gains Tax) Bill 1999* and the Guide to Div. 152.

They concluded that because section 152-140(1)(a) is beneficial in nature, the provision should be construed broadly, so as give the most complete outcome that is consistent with the ordinary meaning of the words used of the legislation.

Statutory interpretation: the relevance of a "label"

The Full Federal Court held that the use of a label, here being "active asset" did not assist in interpreting the provision. The Court referred to long established authority that "it would be quite circular to construe the words of a definition by reference to the term defined".

Was the land an "active asset"?

The Full Court held that the language used in section 152-140(1)(a) required a determination of three things, which are all questions of fact and degree:

- the use of a particular asset;
- the course of the carrying on of a business; and
- whether the asset was used *in* the course of the carrying on of that business.

The Full Court also noted that section 152-140(1)(a) does not contain words that may confine the inquiry as to whether the relevant asset is used in the carrying on of the relevant business. For example, the legislation has not referred to the "ordinary" course of a business or to the "day-to-day" course of a business; it has not used the words "direct" or "integral" to qualify the word "in".

As such, the Full Court held that it is sufficient if the asset is used at some point in the course of the carrying on of an identified business.

The Full Court held that section 152-140(1)(a):

- imposes no requirement for the relevant asset to be used in the course of carrying on the activities of a business “which are directed to the gaining or production of assessable income”;
- does not require the use of the relevant asset to take place within the day to day or normal course of the carrying on of a business; and
- does not require a relationship of direct functional relevance between the use of an asset and the carrying on of a business.

They also rejected the Commissioner’s view that the phrase “inherently connected” for active intangible assets in section 152-40(1)(b) should be used as a reference to a close or direct connection with the carrying on of a business for the purposes of section 152-140(1)(a). In their view, that language applies to the specific difficulties posed by intangible assets (e.g. goodwill).

The Court concluded that the usage of the land as per the ruled facts was **in the course of carrying on the taxpayer’s building, bricklaying and paving business**. In their view, the **ability to secure overnight on a daily basis, and otherwise store, necessary tools and materials is an element of the particular business**, and cannot be said to be outside the course of carrying on that business. In their view, such activity cannot also be said to be preparatory in nature. As such, the use of the property took place “in” the carrying on of that business and the property was therefore an active asset.

Comments

The Full Federal Court decision sheds light on the principles of statutory interpretation, and the approach taken by the Full Court to interpret the legislation in line with the words used and taking into consideration the purpose of the legislation is helpful to taxpayers.

The observation of the Full Court with respect to “labels” used in the legislation is also a useful reminder that it is important to look beyond the label, and instead examine the words used to describe the defined term.

Whilst the case dealt with land, the principles should be equally relevant to other assets. In addition, the case may have broader relevance, particularly in respect of active foreign subsidiaries in Subdivision 768-G of *ITAA 1997*.

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