

John was an architect and was employed by a small firm in the Melbourne CBD. He worked part-time. On his days off, he enjoyed designing and printing T-shirts. He started designing and printing T-shirts in August 2009, when his friend introduced him to the hobby. He printed T-shirts when he had the time and kept them for himself or gave them as gifts for family members for special occasions. As an architect, John had excellent design skills. Most of the time, John came up with new designs and logos etc during his train travel to work.

In January 2010, John started to receive requests for his T-shirts from people outside of his family. Without giving it much thought, John happily obliged and printed T-shirts for these people. He received \$25 per T-shirt and sold about 20 T-shirts in the following 2 months. John always took the money for the T-shirt when the request was received and he promised delivery within 5 business days.

John was keen to make extra income to supplement his architect wage, so on 1 March 2010, he decided to investigate into whether it would be profitable to sell the T-shirts to a wider market. He did some profit projections, conducted some research into how long the equipment generally lasts and enquired into whether he could obtain his materials (such as paint and T-shirts) at wholesale cost. As a result of his investigations, on 6 March 2010, John invested \$2,000 to purchase some additional equipment and materials (such as a large drying rack for the T-shirts, a large quantity of paint, T-shirts and a new printing screen). Other than the drying rack and the printing screen, John did not require any other equipment for printing the T-shirts. John also started to devote more time to designing and printing the T-shirts before he received requests, so that he could meet the demand within the 5 business days of payment as he always promised.

Over the month of March, John sold 30 T-shirts just by word-of-mouth. On 31 March 2010, John decided that if he wanted to sell the T-shirts to a wider market then he needed to advertise his product. On this date, John paid a friend \$500 to set up a simple website to

advertise his T- shirts. John also printed the website on all of the T-shirts that he sold from that date on. The website proved to be popular and John sold 80 T-shirts during the month of April 2010.

Due to the increased sales, John was now spending approximately 35 hours per week on printing the T-shirts. He also commenced a filing system of all of the designs, logos and slogans that he had developed. He researched into what sort of designs were the current fashion in different age groups so that he could target his designs to the most lucrative market. For the first time, in May 2010, John started to also design pants and collared shirts, which he paid to have tailor-made and applied his prints to.

On 15 May 2010, the owner of a chain of cafés, Ron, contacted John and requested him to design a uniform for the café staff. John successfully designed a uniform, which Ron was exceptionally pleased with. As well as looking modern and groovy, it was also very practical. As part of the uniform, John had designed the apron with a special belt, which could hold various attachments such as the electronic ordering pad, a cloth and other items. Ron ordered 200 uniforms for all of the staff across all of the café franchises.

Due to the success of the uniform, John decided to apply for a patent over the apron with the belt. The uniform and belt was patented on 2 July 2010.

In applying for the patent, John became aware of a patent over an automatic clothes folding machine being sold for a bargain price. The seller was in financial difficulties and therefore was selling it for a cheap price. John did some research into the potential income that could be generated from this patent and the popularity of the machine. Although John had never had any experience with such a machine, he thought this might be a good way to make a quick profit.

John purchased the patent for \$4,000 on 15 July 2010. John actively sought to exploit the patent and therefore managed to procure 3 significant parties who were keen to use the patent to build and sell these machines. This significantly increased the value of the patent and John subsequently sold the patent on 18 October 2010 for \$10,000.

REQUIRED:

John seeks your advice about satisfying his income taxation obligations in respect of his printing and designing activities. In particular, advise John of the income tax consequences and implications of:

(a) John's receipts from printing T-shirts and designing clothes/uniforms.

(b) John selling the patent over the automatic clothes folding machine.

In providing your answers, you should ignore GST, you should provide full details and reasons as to why and when amounts are taxable, and you should refer to any relevant case law, legislation and taxation rulings to justify and support your conclusions.

SOLUTION

Various facts and circumstances of the case have to be taken into consideration in the instant case in order to ascertain the tax liabilities and the accessibility of various receipts of money by John over the relevant accounting year. In order to render proper legal advice to John, all these factors have to be taken into consideration and accordingly, a brief discussion of relevant facts as ascertainable from the facts of the case has been undertaken hereunder so that correct advice can be given to John regarding his liability pertaining to receipt from painting and designing T shirts and regarding the liability from purchase and sale of patents.

As the accounting year in the Commonwealth of Australia is from July 1 to June 30th of the next year, for the purpose of tax accessibility, figures and receipts during the relevant time in 2009-2010 have to be taken into consideration. A perusal of the facts of the case discloses that John, who was an architect by profession, worked in a small firm in Melbourne in a part time job. The facts further reveal that John was introduced to the hobby of designing and printing T shirts in the month of August, 2009 by a friend and he started to design T shirts, print them and keep them for personal use or to gift them to someone.

As per the facts of the case, till the month of December, John had continued the entire process as mere hobby. Since January, as per the facts of the case, John started receiving personal orders, though there is no mention of any effort made by John in order to solicit orders till now. During January and February of 2010 John sold around 20 T shirts but the facts still do not disclose any profit motive on part of John. The receipts from sale of T shirts over the month of January and February is an amount of \$ 500/. In the month of March, John decided to analyse and check if he could pursue designing and selling T shirts to increase his earnings in addition to the wages that he earned from his architectural employment. As his investigations were reflecting positive results, he invested \$ 2,000 to purchase certain items

such as large drying rack, paints, T shirts and a printing screen even though the immediate need was of drying rack and printing screen and John presumably purchased paints and T shirts because maybe he got a better deal. In the month of March, John sold 30 T shirts making his receipts for the month to be \$ 750. On 31st March he decided to develop a website and invested \$ 500 in this regard and this resulted in increased sale as he sold 80 T shirts in the month of April, 2010 thus his receipts being \$ 2000. In the month of May John received order of designing 200 uniforms for the cafes owned by Ron and the aprons designed by John became so popular that he decided to patent the aprons with special belt. Moreover, John started filing all his designs, logos and slogans that he developed.

It is submitted here that wages that John earned, being an architect, would form a part of his ordinary income and would also come under the purview of statutory income as well. The important question which arises in the instant case is whether the receipts made by John with respect to printing and designing T shirts would become a part of his assessable income or not.

As long as John was printing and designing T shirts as a part of his hobby, the income accrued out of his pursuit of his hobby would not become a part of his assessable income. In the landmark ruling in case of Stone¹ wherein it has been clearly held that moneys or benefits accrued or received in pursuit of pastime or hobby do not become a part of the assessable income² of the assessee. In this regard, accordingly, it is submitted that the money received to the tune of \$ 500 by sale of 20 T shirts by John during the month of January and February 2010 would not be treated as a part of his assessable income as he had received the money in the pursuit of his hobby of printing and designing T shirts.

¹ TR 1999/17 available at <

<http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~TR~basic~exact:::AND~1999/17~basic~exact&target=EA&style=java&docid=TXR/TR199917/NAT/ATO/00001&recStart=1&PiT=99991231235958&recnum=3&tot=36&pn=ALL:::ALL>> accessed on January 5th 2010.

² See "Australian Master Tax Guide", 45th Edition, 2010 CCH

It is further submitted that for an exercise to be discernible as business as opposed to be a hobby, there should be an expectation and realisation of recurrent and regular income,³ there should be systematic planning and there should be investment pertaining to the exercise so as to raise profit⁴ from the exercise.⁵ Accordingly, as John undertook research and invested money to procure machinery in the month of March and then later on he invested money to develop a website, it clearly shows that he intended to use his talents of designing and printing T shirts for raising income and thereafter the money earned by him by sale of T shirts and uniforms from the month of March 2010 would form a part of the assessable income of John. Another relevant factor to be considered is that in the once he decided to take printing and designing T shirts professionally with profit motive, he used to work around 35 hours a week and it amounts to fulltime work making the receipts thereof to be taxable. It is further submitted that the money invested with a purpose of gaining assessable income is allowed as deduction⁶ by virtue of section 8 of the Income Tax Assessment Act, 1997. In this regard, it is submitted that with respect to machinery, i.e. drying rack and printing screen, John would be eligible to get depreciation and not deduction.

Accordingly, John is advised that the receipts made by him from sale of T shirts and uniforms from the month of January would form a part of his assessable income by virtue of sections 6.5 and 8 of the Income Tax Assessment Act, 1997.

Regarding the profits made by John by virtue of purchase of patent pertaining to automatic folding machine on July 15th of 2010 and subsequent sale on October 18th 2010 for a profit of \$ 6,000 would be treated in the tax calculation for the year 2010-2011 as the transaction does not fall under the purview of last accounting year. The transaction was

³ Barkoczy, S., "Australian Tax Casebook", 9th Edition, 2009 CCH at p 371.

⁴ R Krever, C Black, "Australian Tax Law Cases", (2010), Thomson Reuters, Australia.

⁵ Ferguson v FCT, 79 ATC 4261.

⁶ See "Australian Master Tax Guide", 45th Edition, 2010 at p 889.

undertaken by John with a motive to make quick profit and it was a part of speculation to make profit in short term and actually the transaction was completed in three month only thereby not making assessable as capital gains by virtue of section 108-5(1)(b) of Income Tax Assessment Act, 1997⁷. However, the profits made by John from sale of the patent would become a part of his assessable income by virtue of section 6.5 of Income Tax Assessment Act, 1997⁸ and John is being advised accordingly. Regarding the purchase of patent, it is submitted that purchase of intellectual property is purchase of asset and had been held for a period of more than one year, it would be considered under the head of capital gains upon its sale. However, as GST provisions have not to be applied in the instant case, the profits made by sale of the patents on automatic folding machine would be subject of trading profits which would become a part of assessable income of John for the next accounting year.

Regarding the expense incurred in getting the intellectual property protected in the form of patent on apron and his designs, logos and slogans, John would be able to claim depreciation under the provisions of division 40 of the Income Tax Assessment Act, 1997.⁹

⁷ R Woellner, S Barkoczy, S Murphy & C Evans, "Australian Taxation Law", (2009) 19th edition CCH.

⁸ See section 6.5 of Income Tax Assessment Act, 1997.

⁹ See Div 40 of the Income Tax Assessment Act, 1997.

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