

LECTURE 8 & 9 – GENERAL DEDUCTIONS

CH 12, 16, 13, 23

INTRODUCTION

s.4-10 ITAA97 → Tax payable = (Taxable Income x Tax Rate) – Tax Offsets

s.4-15 ITAA97 → Taxable income = Assessable Income – Deductions

1. Add up all assessable income for the income year
2. Add up all deductions for the income year
3. Subtract deductions from assessable income UNLESS it exceeds it → end result is your taxable income

Deductions



General Deductions
s. 8-1 ITAA97



Specific Deductions
s. 8-5 ITAA97

- General deductions:
 - Must satisfy 1 positive limb of s.8-1 AND not caught by any of the 4 negative limbs
- Specific deductions:
 - Deductions that are made allowable because of a specific provision in the legislation → listed out in s.12-5 ITAA97
- Can only deduct once under the provision that is most appropriate even if 2 or more provisions allow you deductions of the same amount → s.8-10 ITAA97

NOTES:

- If deductions are MORE than assessable income = tax loss and you can use as a deduction in the later income year → see Div 36
- Tax loss ≠ net capital loss

SUBSTANTIATION OF DEDUCTIONS

Div 900 ITAA97

- TP must be able to substantiate deductions = maintain adequate records and documentation
 - Name of supplier
 - Amount of expense
 - Nature of good/service
 - Dates

s.900-165 (5 years)

- specific record requirements for cars
- some exemptions
 - eg. Up to \$300 work expenses or \$150 laundry without records

S.8-1(1) ITAA97's two positive limbs

- You can deduct from your assessable income any loss or outgoing to the extent that:
 - a) It is incurred in gaining or producing your assessable income OR
 - b) It is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income
- ONLY ONE LIMB NEEDS TO BE SATISFIED

S.8-1(2) ITAA97 four negative limbs

- Cannot deduct a loss under this section if:
 - a) If it is a loss or outgoing of capital or of capital nature OR
 - b) It is a loss or outgoing of private or domestic nature OR
 - c) Incurred in relation to gaining or producing your exempt income or non-assessable non-exempt income OR
 - d) A provision of this act prevents you from deducting it
- If expense is caught by one of the above, it will not be allowed as a general deduction

"LOSS OR OUTGOING"

- Used in both positive and negative limbs
- Loss occurs when TP's financial resources have been diminished
 - Eg. Money stolen from a business or loss on a land development profit making scheme
 - Charles Moore & Co (WA) P/L v FCT (1956)
- Outgoing involved some form of payment, outlay or expenditure
- Determining whether loss or outgoing is not an issue in claiming a deduction under s.8-1
- A loss or outgoing is deductible "to the extent" that ONE of the POSITIVE limbs and NONE of the NEGATIVE limbs are satisfied
- Allows for apportionment of expenses where an expense is only partially for gaining or producing assessable income
- No formula for apportionment → must NOT be a random basis
- Fair and reasonable division on a case by case basis → Ronpibon Tin NL v FCT (1949)



EXAMINING THE POSITIVE LIMBS

"Incurred" – timing issues

- "Incurred is not defined in statute
- provisions based on anticipated future events generally not allowed as deductions
- Judicial interpretation
 - Required fixed liability not subject to contingencies
 - FCT v James Flood (!953)
 - Nilsen Development Laboratories P/L v FCT (1981)
 - S.26-10 ITAAA97 for annual leave provision
 - Insurance companies → RACV insurance P/L v FCT (!974)
- Commissioner interpretation in TR 97/7
 - "you owe present money debt that you cannot escape"

SUFFICIENT NEXUS/LINK

- Must establish a link/nexus between the loss or outgoing AND either:
 - a) The production of assessable income → 1st limb OR
 - b) The carrying on of a business for the purpose of producing assessable income → 2nd limb
- Cases requires the loss/outgoing:
 - To be "incidental and relevant" to the TP's income producing or business operations AND
 - Have essential character of an income producing or business expense
 - ie. Sufficiently connected to the carrying on of a business aka incurred in the course of... AND
 - has the character of a business expense

SUFFICIENT NEXUS EXAMPLES

- Herald and Weekly Times Ltd v FCT (1932)
 - Necessarily incurred in carrying on a business
 - The liability to damages was incurred because of the publishing of the newspaper which the thing which produced assessable income
 - Damages therefore deductible
 - Pg 366
- W Nevill & Co v FCT (1937)
- Charles Moore & Co P/L v FCT
 - Losses incurred in the course of gaining or producing assessable income
 - Loss incurred as apt of normal business operation and satisfied ostiive limbs
 - About stolen cash when going to bank
- FCT v Day
 - Legal expenses incurred in defending improper conduct chargers
 - Legal expenses incurred in gaining assessable income
 - Officier defended himself against charges – charges only arose due to his position – exposed him to the charges
- FCT V Snowden & Willson P/L
 - Necessarily incurred in carrying on a business
 - Law firm subject to complaints
 - TP incurred expenses on advertising and legal fees to defend reputation
 - Courts said expenses deductible
 - Necessarily incurred and expenditure dictacted by business prupose
- Magna Alloy & Research P/L v FCT
 - Legal expenses incurred in defending criminal charges
 - Expenses primarily related to the director's defence
 - Court said they were necessarily incurred in carrying on a business to gain or produce assessable income
 - Expenses were dedcutibel
- FCT v La Rosa
 - Expenses related to illegal business
 - Loss deductible as it was necessarily incurred despite illegal nature

Expenses to reduce future expenditure

- W Nevill & Co Ltd v FCT
 - Necessarily incurred in carrying on a business
 - Managing director terminated and compensation payment made
 - Payment satisfied positive limb and deductible

- Original agreement with managing director was entered into in the production of assessable income
- Compensation payment which resulted from an amendment to the original agreement → must therefore also be for the purpose of gaining assessable income
- This is an expense to improve taxpayer's overall business efficiency and operation
- Court found that it is an expense that reduces a TP's future deductible expenditure incurred in gaining assessable income

Involuntary losses or outgoing

- Pg 369

IS THERE SUFFICIENT TEMPORAL NEXUS OR CONNECTION TO SATISFY THE POSITIVE LIMBS

Expenses related to the production of assessable income in future years

- Steele v DCT

Expenses related to the production of assessable income in prior years

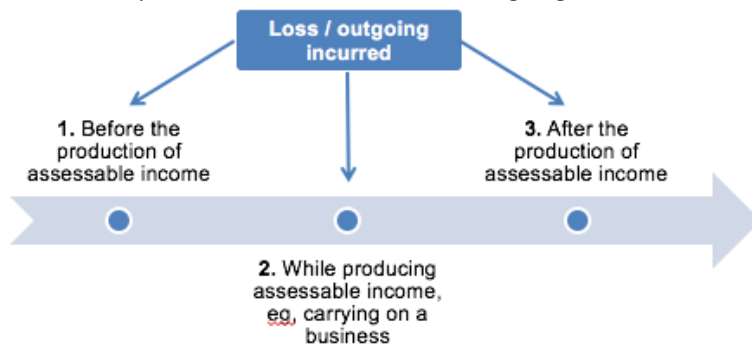
- Placer Pacific Management P/L v FCT
 - Expenses related to the production of assessable income in prior years
 - Allowed a deduction as they arose out of or were caused by TP's past activities of manufacturing conveyor belts

INSUFFICIENT NEXUS

- Expenses incurred to put someone in a position to produce assessable income → not allowable deductions
 - Eg. Childcare, travel to work costs
- Not enough that expense is a pre-requisite for the TP to be in a position to earn assessable income

TIMING ISSUE

- Is there a sufficient nexus where there is a gap in time between gaining assessable income and incurring the loss or expense?
- The point of time when the loss or outgoing is incurred is a factor in determining whether there is a sufficient nexus



Before the production of assessable income

- Generally insufficient nexus → therefore NOT deductible
 - Where a business has not yet commenced → Softwood Pulp and Paper Ltd v FCT (1976)

After the production of assessable income

- Likely to be sufficient nexus → therefore deductible IF expenses related to the prior earning activity
 - Satisfaction of obligations arising from previous business → Placer Pacific Management v FCT (1995)
 - Interest expense on a business → FCT v Brown (1999) & FCT v Jones (2002)

GAINING OR PRODUCING ASSESSABLE INCOME

- Broadly interpreted → ie. Do not need to look at the direct impact of the expenses on the TP's production of assessable income → ie. Look at overall activities of the TP
 - Interpreted as"in the course of gaining or producing assessable income → FCT v Day (2008)

MEANING OF "NECESSARILY" IN THE 2ND POSITIVE LIMB → S.8-1(1)(b)

- S.8-1(1)(b) is broader than s.8-1(1)(a)
- There may be expenses necessary to operate a business that would not clearly satisfy s.8-1(1)(a)
- Business judgement rule → it is for the business to determine what is necessary NOT the courts or the Commissioner
- Look at Ronpibon Tin NL v FCT

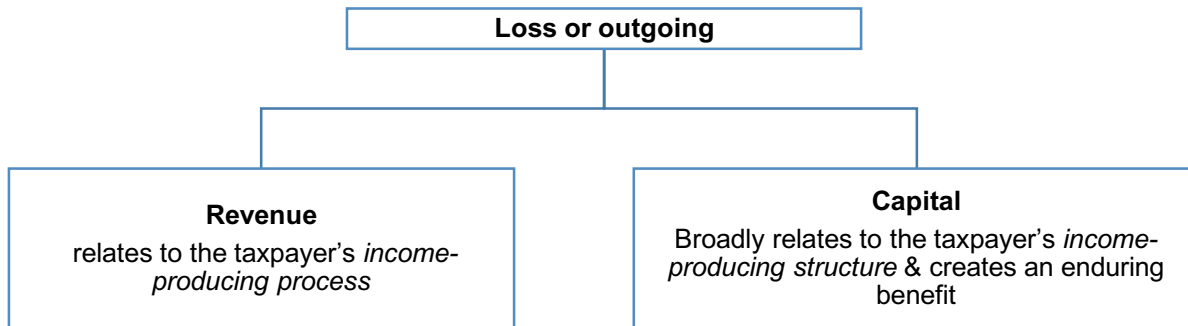
EXAMINING THE NEGATIVE LIMBS

- Expense is NOT deductible to the extent that it is satisfied by any one of the negative limbs
- "to the extent" means the outgoing is partially deductible if it is partially satisfied by a negative limb
- Negative limbs are
 1. Capital or capital in nature
 2. Private or domestic
 3. Incurred in gaining exempt or non-assessable non-exempt income OR
 4. Prevented from being deducted by a specific provision of the income tax legislation

CAPITAL OR CAPITAL IN NATURE

- No clear test in legislation as to when an expense will be characterised as a capital expense

- Distinction between REVENUE expenses and CAPITAL expenses
- Has been difficulties formulating guidelines to distinguish between capital and revenue outgoings



- Judicial tests form UK
 - Vallambrosa Rubber Co Ltd v Farmer (2010) → expenditure spend on an “once and for all” basis is CAPITAL or recurring basis is REVENUE
 - British Insulated and Helsby Cables Ltd v Atherton (1926) → expenditure made to bring an asset into existence or to bring an advantage for an enduring benefit
- Australian tests to distinguish the difference → Business Entity test
- Sun Newspaper Ltd & Associated Newspaper Ltd v FCT (1938)
 - SN paid instalments to rival publisher to not have rival newspaper published for 3 years in 300 mile radius
 - Held payment by SN was capital
 - Because outings were of large sum
 - They were incurred to remove a competitor → related to the structure of the business
 - Main object of the expenditure was to strength and preserve the business and to acquire an asset
 - Outcome was that it was capital in nature