General Deductions

- Deductions are divided into two categories and their corresponding sections:
  - General Deductions: **s 8-1 ITAA97**
  - Specific Deductions: **s 8-5 ITAA97**
- Expenses that may be deductible under both divisions, should be deducted under the most appropriate section: **s 8-10**
  - As a general rule of statutory construction, the specific rule applies over the general rule
  - If a deduction does not qualify for the specific provision, consider deductibility under **s 8-1**

General Deduction Rule

Positive Limbs:

Under **s 8-1(1)** a taxpayer can deduct from his or her assessable income a loss or outgoing to the extent that it is:

- ✓ Incurred in gaining or producing assessable income, OR
- ✓ Necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income

ONLY ONE NEEDS TO BE SATSIFIED!! (extent may mean partial deduction applies)

Negative Limbs:

However, a loss our outgoing is not deductible under the general deduction rule if it satisfies any of the negative limbs: **s 8-1(2)**

1. Capital or capital in nature;
2. Private or domestic;
3. Incurred in gaining exempt or NANE income; or
4. Prevented from being deducted by a specific provision of income tax legislation

Loss or Outgoings

- **Section 8-1** applies to both a loss and outgoings
  - A loss is a depletion of a taxpayer's financial position: **Charles Moore & Co (WA) Pty Ltd v FCT (1956)**
  - Outgoings are expenses

NEXUS TEST – POSITIVE LIMBS OF S 8-1

- The first positive limb requires a **nexus** between the loss/outgoing and the gaining or production of assessable income
- The second positive limb requires a **nexus** between the loss/outgoing and the carrying on of a business to produce assessable income

"Gaining or producing assessable income"

- ➢ This phrase is interpreted by the courts as in the course of gaining or producing assessable income: **Amalgamated Zinc (De Bavay's) Ltd v FCT (1935)** - taxpayer who previously carried on a mining and zinc business sought to deduct compulsory contributions made to workers years after the business had ceased, deductions were denied, however decision would most likely be reversed today

- ➢ There must be a sufficient connection between the loss or outgoing and the production of assessable income or the expectation to produce assessable income

Judicial Tests

- The courts have adopted a number of approaches to determine whether a loss or outgoing is incurred in the course of gaining or producing assessable income (to satisfy nexus requirements)

1. Incidental and Relevant Test

- Under this test, a loss or outgoing would be sufficiently connected to the production of assessable income where the expenditure … is incidental and relevant to the operations or activities regularly carried on for the production of income
- **W Nevill & Co Ltd v FCT (1937) –** the taxpayer was a company that had two management directors, one of their contracts was terminated for poor performance and a compensation payment was made, held to be deductible as the original agreement with the managing director was entered into in the production of assessable income

2. Essential Character Test
   - Under this test, the courts have looked at the 'essential character' of an expense to determine whether it is sufficiently connected to the production of assessable income
   - *Home to work travel expenses:* essential character was to put the taxpayer in a position to gain or produce assessable income, not the production of assessable income
   - **Lumney v FCT; Hayley v FCT (1958) –** authority that commuting to work expenses are personal, non-deducible outgoings as they are incurred to enable someone to be in a position to carry out work
3. Occasion and Expenditure Test
   - Under this test, the courts have considered whether the occasion of the expenditure arises out of income-producing activities
   - This test requires an assessment as to what is productive of the taxpayer's assessable income
   - **FCT v Payne (2001) –** Qantas pilot case
   - **FCT v Day (2008) –** taxpayer was a customs officer who was charged with failing to fulfil his duties, he incurred legal expenses in defending the charges, court found that the legal expenses were incurred in gaining or producing assessable income as the occasion of the expenditure arose out of his income producing activities as a customs officer

Is the Nexus sufficiently direct or too remote to satisfy the positive limbs?

- If a nexus between the expense and the production of assessable income is too remote, it is not deductible
- Some cases exist where it is questionable as to whether a nexus can be established:

1. Expenses involving alleged or actual wrongdoing

- Nexus satisfied for expenses arising from alleged or actual wrongdoing incurred by:
  - Employees defending improper conduct chargers which are "quasi-personal" (incurred in a personal rather than professional capacity): **FCT v Day (2008)**
  - Business taxpayers in respect of defending claims (eg. libel actions or defamation claims) arising out of the ordinary course of business:
    - **Herald and Weekly Times Ltd v FCT (1932) –** taxpayer was a newspaper publisher who incurred expenses from being sued from publishing information, however it was published with the sole purpose of selling newspapers which produced their assessable income, therefore deductible (potential for libel claims was regular for publishing, sufficient connection between expense and business)
    - **FCT v Snowden & Willson Pty Ltd (1958) –** taxpayer was a building company and received complaints. Expenses were incurred on advertising and legal fees defending its reputation, they were deductible as they enabled the business to continue operation and gain or produce assessable income through protecting their reputation
  - Company directors incurring costs to defend criminal chargers:
    - **Magna Alloys & Research Pty Ltd v FCT (1980) –** taxpayer incurred legal expenses in defending itself and its directors in criminal proceedings, accused of illegal commissions to boost sales of products. Held to be deductible as the legal expense were necessarily incurred in carrying on a business to gain or produce assessable income
  - Expenses related to illegal business: **FCT v La Rosa (2003) –** taxpayer was a convicted drug dealer who was robbed of cash during an intended drug purchase, the loss was deductible as it was necessarily incurred in carrying on the taxpayer's business to gain or produce assessable income
    - HOWEVER, **s 26-54** was enacted and denies a deduction for a loss or outgoing incurred from illegal activities

2. Expenses to reduce future expenses

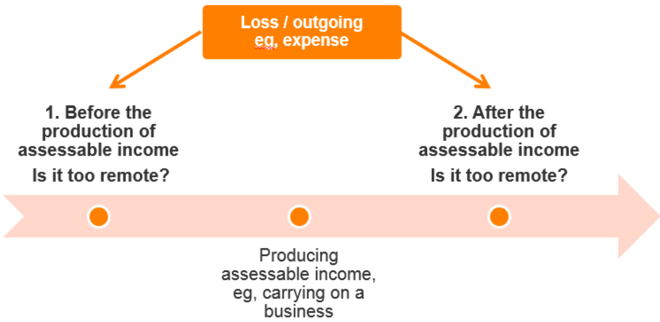
- Nexus established between an expense that improves the taxpayer's business overall and reduces future expenses
  - Termination payment to end a contract of employment for poor performing director: **W Nevill & Co Ltd v FCT (1937)**

3. Involuntary losses or outgoings

- Nexus established between an involuntary loss where it arises out of the taxpayer's income producing activities
  - Earnings stolen while on the way to the bank: **Charles Moore & Co (WA) Pty Ltd v FCT (1956) –** taxpayer was a retail company and the normal operations included an employee taking money to the bank daily, robbery occurred, loss was deductible as it was incurred in the course of gaining or producing assessable income

Sufficient Temporal Nexus

- An issue may arise as to whether a nexus can be established where expenses are incurred before the production of assessable income or after



1. Expenses related to the production of assessable income in future years

- An expense incurred to gain or produce assessable income the future may satisfy the nexus requirement
  - Interest associated with the purchase of an asset which was expected to produce income in the future was deductable: **Steele v DCT (1999) –** taxpayer who wanted to create the hotel business
  - COMMITEMENT
- However, nexus may not be established where:
  - The expense is too preliminary for a business that has yet to commence: **Softwood Pulp and Paper Ltd v FCT (1976) –** the Canadian company who wanted to set up a paper mill and conducted the feasibility study, not deductible
  - NO COMMITMENT
  - The expense is to put an employee in a position to gain or produce assessable income: **Lumney v FCT; Hayley v FCT (1958)**

2. Expenses related to the production of assessable income in prior years

- Likely to be deductible providing the expense relates to the time when the business was operating
  - **AGC (Advances) Ltd v FCT (1975) –** established the principle that provided the loss or outgoing was incurred in relation to business operations directed towards gaining or producing assessable income general, regardless that the business may have ceased, it will not affect issues of deductibility (applied to the next cases and overrules the **Amalgamated case**)
  - Satisfaction of obligations arising from previous business
    - **Placer Pacific Management Pty Ltd v FCT (1995) –** taxpayer incurred expenses in satisfying obligations arising out of its previous business of manufacturing conveyor belts, deduction allowed as they were caused by the taxpayer's past business where it produced assessable income
  - Interest expense on a business:
    - **FCT v Brown (1999) –** taxpayer and his wife borrowed funds to acquire a deli business, debt repayable over 10 years, they sold the business but an amount still remained on the loan,

interest outgoings held to be deductible as the loan was incurred for the business operations to gain or produce assessable income

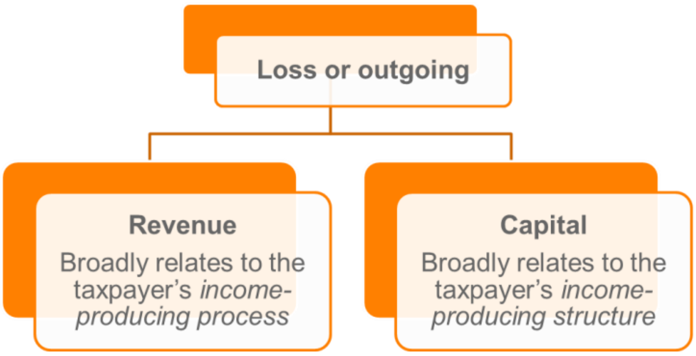
- **FCT v Jones (2002) –** taxpayer and her husband carried on a business until his death and was funded by bank borrowings, loan amount was still outstanding and taxpayer refinanced the loan to get a lower interest rate, the interest expenses were allowable deductions (taxpayer was attempting to repay the debt but did not have the capacity to do so)

NON-DEDUCTIBLE EXPENSES – NEGATIVE LIMBS OF S 8-1

- An expense is not deductible to the extent that it satisfies any of the negative limbs
  - "To the extent" means the expense is partially deductible if it partially satisfies a negative limb

Capital or Capital in Nature

- Under **s 8-1(2)(a)** a loss or outgoing that is capital or capital in nature will not be deductible under **s 8-1**
- Distinction between "revenue" expenses and "capital" expenses
- There is no clear test in the legislation as to when an expense will be characterised as a capital expense:



- Revenue expenses relate to the income producing process – how does the taxpayer make their money?
- Capital expenses relate to the income producing structure – how is the business being impacted?

Earlier judicial tests include:

- Expenditure spent on an "once and for all" basis (capital) or recurring basis (revenue)
  - **Vallambrosa Rubber CO Ltd v Farmer (1910) –** taxpayer incurred expenses maintaining and developing a rubber plantation, expenses were deductible as the taxpayer incurred similar expense each year (revenue) and even though they related to future year's income (incorporated in the Sun case)
  - This test proved to be too simplistic as it only required an examination of the form of the expense
- Expenditure made to bring an asset into existence or to bring an advantage for an enduring benefit
  - **British Insulated and Helsby Cables Ltd v Atherton (1926) –** the court held that the expenditure for the enduring benefit was attributable to capital

Key Judicial Decision:

★ To distinguish between business processes (revenue) and business structure (capital) the following case was used:

- **Sun Newspapers Ltd and Associated Newspapers Ltd v FCT (1938) –** the taxpayer's competitor was the World published by Sydney's Newspapers Ltd who proposed to introduce a rival paper called the Star which would compete against the Sun (owned by the taxpayer)
  - The taxpayer made a payment to Sydney Newspapers for the right to use its plant and equipment for a period of three years and for an agreement that it would not establish a new newspaper for the same period
  - The payment resulted in Sun Newspapers shutting down an existing rival newspaper, the World and preventing the publication of a new rival, the Star, for 3 years (MONOPOLY)

- The court held that the payment was non-deductible capital expense as the taxpayer had acquired an enduring benefit by shutting down its competitor, it also strengthened the taxpayers business structure

★ **3 FACTORS TO CONSIDER:**

1. *Character of the advantage sought* – whether the expense has a lasting (capital) or temporary (revenue) benefit
2. *Manner in which the benefit is used, relied upon or enjoyed* – requires a consideration of whether the benefit is used once and for all (capital) or recurrently (revenue)
3. *Means adopted to obtain the benefit* – whether the benefit was obtained through a one-off payment (capital) or recurrent payment (revenue)

All factors need to be considered together to reach a conclusion!

- However, despite the Sun Newspaper case, it is difficult to characterise expenses as revenue or capital:
  - Revenue in Nature – **BP Australia Ltd v FCT (1965):**
    - Taxpayer was a petrol wholesale
    - Entered into "tied house" agreements with several service stations for around 5 years which meant the taxpayer's petrol was sold exclusively (considered short exclusivity period)
    - Benefit was to be used in the continuous and recurrent sale of petrol
    - Lump sum payment (not particularly useful)
  - Capital in Nature – **Strick v Regent Oil CO Ltd (1966):**
    - Taxpayer secured exclusive sales ties through a lease premium arrangement (inducements)
    - The retailers leased their stations to the taxpayer for between 10 and 20 years in exchange for a lump sum (substantially longer than BP Australia)
- The courts will also examine the substance of a payment and not just its form:
  - Revenue in Nature – **National Australia Bank Ltd v FCT (1997):**
    - Taxpayer made a large lump sum payment to the government to become the exclusive lender under a government loan scheme
    - The court held that the lump sum payment was a deductible revenue expense as the taxpayer sought to increase customers base and income from loans
    - Also no monopoly was created, as customers could go to other banks
  - Capital in Nature – **Colonial Mutual Life Assurance Society Ltd v FCT (1953):**
    - Taxpayer purchased a block of land
    - Payments were in the form of a "rent charge" with monthly payments over 50 years
    - Held to be a capital expense as they were merely consideration for the acquisition of the land
  - Substance versus Form – **FCT v Star City Pty Ltd (2009):**
    - Taxpayer had an exclusive license to operate a casino in Sydney
    - Government granted the taxpayer a 99 years lease for the land and 12 year license to operate the casino
    - Taxpayer paid $120m which was described as prepaid rent for the first 12 years of land rental
    - Rent was a capital expense (benefits enduring)