Topic 8

Deductions and Capital Allowances

How to approach general deductions:

- examine the extent that a loss or outgoing satisfies either of the two positive limbs
- if, one/both of the positive limbs are satisfied, determine the extent that the loss or outgoing is excluded under any of the four negative limbs

Positive limbs

- 8-1(1) 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 assessable income.

Loss or outgoing

- a "loss" arises where a taxpayer's financial resources have been diminished (interpreted fairly broadly)
- an "outgoing" involves some kind form of payment, outlay or expenditure

To the extent that

- indicates that a loss/outgoing may need to be apportioned, in which case it will only be partly deductible
- case: *Ure v FCT*
    - interest expenditure by a taxpayer on a loan used for both income producing and private purposes should be apportioned between those objects

Nexus between loss/outgoing and positive limbs

- courts have traditionally adopted a broad view
- not necessary to show a connection between an outgoing and any particular item of income; it is sufficient if the outgoing is a "step towards the production of income" (*Ash v C of T)*
- deductible expense does not necessarily have to produce income in that income year, if it is designed to earn income in future years it should be able to (*FCT v Smith or Fletcher Ors v FCT)*

Different approaches to establishing a nexus:

- pragmatic and commercial approach
    - i.e. will view the outgoing from a commercial point of view to see whether it was intended to improve business/produce income
    - cases:
        - *W Nevill & Co Ltd v FCT*
            - company allowed deduction for consideration paid to employee in return for him agreeing to resign
        - *Herald and Weekly Times Ltd v FCT*

        - costs incurred in defending and settling an action brought against it for alleged defamatory articles it had published were deductible
- the "in the course of" and "incidental and relevant" tests
    - "in the course of"
        - courts have indicated that the nexus requirement is satisfied where a loss or outgoing is incurred in the course of gaining/producing income *(Amalgamated Zinc Ltd v FCT)*
    - "incidental and relevant"
        - to the operations or activities regularly carried on for the production of income *(W Nevill & Co Ltd v FCT)*
    - both relate to the nature or character of outgoing rather than frequency, expectedness or likelihood of occurrence
- the "character" test
    - established in *Charles Moore & Co*
    - just because an employer requires an employee to incur an expense, this does not necessarily mean that the expense is deductible *(FCT v Cooper; rugby player's diet case)*
- characterising outgoings by reference to objective advantages obtained
    - courts refer to the legal rights or advantages that the taxpayer obtains from incurring the expenditure
    - objective look *(Cecil Bros Pty Ltd v FCT)*
- characterising outgoings by reference to subjective purpose
    - Magna Alloys & research Pty LTD v FCT
    - sometimes important to consider the subjective purpose of taxpayer, which may change it from not being incurred for business, the the alternative
    - if objectively looking at case points to one outcome but courts are not convinced, they have the flexibility to take into account subjective intentions of the taxpayer instead
    - *Ure v FCT*
    - *Fletcher & Ors v FCT*
    - both of these cases demonstrate that the courts will take a taxpayer's subjective purpose into account to characterise "colourable" or "voluntary" outgoings, where the amount of income produced is less than the amount of the outgoings incurred
    - when this disproportion can only be explained by reference to some non-income producing purpose, the courts will apportion or even disallow the deductions
- Note, the courts will take into floodgate argument i.e. if one is allowed, will everybody try to claim this deduction and is it viable?

Necessarily incurred in carrying on a *business

- necessarily incurred interpreted liberally
- *Snowden & Wilson Pty Ltd*
    - taxpayer allowed deductions for costs incurred in defending their business practices before a Royal Commission and in placing newspaper advertisements presenting their "side of the story"
    - this satisfied "necessarily incurred"

- the courts are unwilling to tell taxpayers how to run their own businesses
- outgoing does not need to be either unavoidable or essentially necessary, must instead be appropriate and adopted for the ends of the business carried on for the purpose of earning assessable income *(Magna Alloys & Research Pty Ltd v FCT)*
- Note: Properly referable
  - It is sometimes not enough that a loss or outgoing has been incurred. The outgoing must also be properly referable to the year of income in which the deduction is sought: *Coles Myer Finance Pty Ltd v FCT*

Contemporaneity Requirement/Temporal Connection

- outgoings incurred <u>before</u> the commencement of business
  - generally not incurred "in the course of"" business and therefore are not deductible under general deductions (*Softwood Pulp and Paper luff v FCT)*
  - whether or not the taxpayer had fully committed themselves to the project and made a final definitive decision to this effect may be relevant
- outgoings incurred <u>after</u> the cessation of business
  - originally outgoings were not deductible *(Amalgamated Zinc Ltd v FCT)*
  - however, ore recent cases have distinguished themselves from this
  - *AGC Ltd v FCT* and *Placer Pacific Management Pty Ltd v FCT*
    - these cases suggest that provided the taxpayer's business operations are the "cause" of an outgoing, even though the business may have ceased, the outgoing may still be deductible

<u>Relationship between the limbs:</u>

- 2nd limb applies to taxpayers carrying on a business:
  - Ronpibon Tin NL v FCT – 2nd limb adds little to 1st
  - John Fairfax & Sons PL v FCT - Limbs are not mutually exclusive. 2nd limb may cater for abnormal events where outlay caters for the purposes of the business generally

Tutorial Answers Sample

1. PK is sad to see Jen go, they also realise that they don't want her working in another law firm. They therefore pay her $500,000 not to work in a competing public practice for 5 years.

Indicator	Yes (O.I.)	No (O.I.)
Character of payment in hands of taxpayer		Appears to be a payment for entering into a restrictive covenant which are generally of a capital nature. See FCT v Woite; professional footballer signed agreement with North Melbourne that if he ever decided to play football in Victoria it could not be a club other than North Melbourne.
Cash or convertible into cash	Cash.	
Must 'come in' to the taxpayer	Has come in.	
Nexus with an earning activity		Not being paid to work for PK, but rather to not work for their competitors.
Periodicity, recurrence, regularity		Once-off.

Conclusion: Not ordinary income.

2. The PK firm also carries out a cash collection from staff and partners which enables PK to give her a gold watch and a Westfield shopping voucher in the amount of $2,000.

Indicator	Yes (O.I.)	No (O.I.)
Character of payment in hands of taxpayer		Personal gift or testimonial.
Cash or convertible into cash	Voucher is convertible into cash.	Watch is not convertible into cash.
Must 'come in' to the taxpayer	Voucher has come in.	Watch has not come in.
Nexus with an earning activity		Not connected to any specific service rendered, more likely to be seen as a parting gift. Analogous to Seymour v Reed; professional cricketer received money collected from a benefit match that had been organised to mark his retirement. NB if it had come from their own coffers and hadn't been collected it would have been different.
Periodicity, recurrence, regularity		Once-off.

Conclusion: Not ordinary income.

Question 3

A student at UWA has won a scholarship of $6,000 per annum from an IT company. A condition of the scholarship is that the student will work for the company for a period of 2 years after graduating from UWA. Is the scholarship assessable income or exempt income?

Required pre-reading

• Foundations of Taxation Law – Chapter 10 and paragraph [12.2]

• ITAA97 – ss 6-5, 6-10, 6-20, 15-2, 51-10, 51-35

How to answer this question:

- definition of assessable income
- test if its ordinary income according to 5 requirements
- check if its in statute law or if it is exempt, not assessable non exempt
- address whether it's exempt or not.

Assessable income = ordinary income + statutory income (s6-5 ITAA97).

Is it ordinary income?

Indicator	Yes (O.I.)	No (O.I.)
Character of payment in hands of taxpayer	Conditional gift for future employment. Motive for person making amount is to gain their employment, inducement.	Conditional gift for future employment.
Cash or convertible into cash	Yes.	
Must 'come in' to the taxpayer	Yes.	
Nexus with an earning activity	Connection with future employment.	
Periodicity, recurrence, regularity	Annual payment for two years, has an element of regularity to it.	

Therefore: should be considered ordinary income.

Is it statutory income?

- s15(2) of ITAA97, includes among examples of statutory income 'rendered services' which refers to past tense therefore not statutory income as this payment is for future services

Given that it may be considered assessable income, can it be made exempt or non-assessable non-exempt income?

- ITAA97 s51-10
  - If you are a **full-time student** at a school, college or university the following amounts are exempt from income tax: a scholarship, bursary, educational allowance or educational assistance, subject to these exceptions and special conditions: see section 51- 35
  - assuming that the student was a full time student then this will apply
- ITAA97 s51-35
  - Payments to a full-time student at a school, college or university

- The following payments made to or on behalf of a full-time student at a school, college or university are <u>not exempt from income tax</u> under item 2.1A of the table in section 51-10:
  - (c) a payment by an entity or authority on the condition that the student will (or will if required) become, or continue to be, an employee of the entity or authority;
  - (d) a payment by an entity or authority on the condition that the student will (or will if required) enter into, or continue to be a party to, a contract with the entity or authority that is wholly or principally for the labour of the student;

Tutorial 3

Question 1

Mrs Beach (who works as an accountant in Perth) goes to Dunsborough in the South West of WA for a holiday. While there, she sees a double block of land for sale which has a nice view over the ocean. Mrs Beach thinks that the land would be perfect for her dream home and, as she is retiring and has no children, decides that it would be nice to have some people around her by leasing out the excess land.

The next day, Mrs Beach has coffee with a friend (in the real estate industry) who suggests that she fence off one of the blocks, put in a garden and lease out 1 or 2 plots to short term campers. Mrs Beach and her friend use the back of a napkin to make some calculations about the likely income from these activities. They conclude that the activities should be cash-flow positive in the second year. Mrs Beach also checks with the Busselton City Council whether a licence is required.

That evening Mrs Beach compares the projected income from the extra land against the amount of interest that she would earn if she sold the extra land and deposited an amount equal to the value of the excess land with a bank. She jots down these numbers in a scrapbook along with her resolution to conduct an annual review of the activities and to sell the excess land if, after a 3 year period, the actual income proves to be less than 75% of the interest she would otherwise have earned.

The following day Mrs Beach signs a contract to purchase the land for $1.5 million plus legal fees of $10,000 and stamp duty of $65,000 and arranges for the house to be built. One year later, once the house has been completed, Mrs Beach places an advertisement in the local South West newspaper and on a sign on the verge. She has 7 campers over the next year. Accordingly, Mrs Beach fails to meet the 75% threshold for the year.

In the following year, Mrs Beach has a similar number of campers, but, at the request of several of the campers, she also sells 2 small portions of the excess land (10% of the total land) to those campers to use as holiday shacks for $250,000 each.

Which of the following amounts might form part of Mrs Beach's assessable income?

(a) Rent from campers in the first or second year of renting the land

(b) 2 x $250,000 from sale of excess land

Do <u>not</u> consider the CGT small business concessions or the main residence exemption.

Required pre-reading

- Foundations of Taxation Law – Chapters 10 and 19
- ITAA97 – ss 6-5, 6-10, 6-20, 102-5, 118-20, 104-10, 116-20, 110-25, 112-25, 115-5

Answer

a) Rent from campers in the first or second year of renting the land.

Assessable income is equal to ordinary income plus statutory income (ss6-5, 6-10 ITAA97).

- Is it ordinary income?
  - Periodicity, regularity, recurrence?
    - reasonable regular, 7 times in one year
  - Cash or convertible into cash?
    - yes
  - Came in to taxpayer?
    - yes
  - Character of payment?
    - rent, typically income (Adelaide Fruit)
  - Nexus with earning activity?
    - income from a business?
      - is she carrying on a business?

Indicator	Yes, It is a business	No, it isn't a business.
Scale and Magnitude		Reasonably small scale.
Systematic/ Commercial manner?	Yes, kept a book, made calculations, use of system; had plan for period of time (see FCT v JR Walker). Advertisement indicates that she is willing to operate in commercial manner (FCT v Pavona)	
Profit Motive?	Mrs Beach's motive can be seen as being motivated by profit. This is evidenced by her consulting a real estate agent, making calculations about the income of the activities and keeping a scrapbook etc. She compares the money she would make by engaging in this activity versus simply depositing the money in the bank and had benchmarks to reach. She engaged in planned activities. As such she clearly has a view for profits. - See Myer Emporium case; she always had the intent to make a profit - See also Whitfords Beach; This would be considered a business scheme to make a profit, if it had originally been to have companionship; by engaging in systematic actions and consulting with a real estate agent etc. this changed into a business.	- wanted companionship - retirement - plans were only written on napkin and scrapbook

- What is scope of business? Is the rent an ordinary proceed of this business?
  - short term rentals seems to be nature of business
  - this would receipt therefore be more likely than not be classified as ordinary income