DEDUCTIONS AND TRADING STOCK

Part 1: Deductions

Introduction

- Section 8-5 ITAA 97 provides for specific deductions.

- Section 8-10 ITAA 97 indicates that if two or more provisions of the Act allow for a deduction in respect of the same amount, the deduction can only be made under the provision that is most appropriate.

Income Tax = (Taxable income x Tax rate) - Tax offset

Taxable income = Assessable income - Deductions

Deductions = (General deductions + Specific deductions) - exclusions

General deductibility and section 8-1

- The basic structure of the legislation is to provide for general deductions under section 8-1 ITAA 97 and specific deductions as identified in sections 8-5 ITAA 97 and 12-5 ITAA 97.

- The first subsection contains what is known as the two positive limbs.
  Under the first two positive limbs of s 8-1(1) a deduction is available from your assessable income:

  - (a) [First positive limb] for any loss or outgoing to the extent that it is incurred in gaining or producing your assessable income

    or

  - (b) [Second positive limb] for any loss or outgoing to the extent that it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

- Under the second subsection of s 8-1, s 8-1(2) ITAA 97 indicates that even if the positive limbs are satisfied, a deduction is still not allowable to the extent that the loss or outgoing is:

  - of capital or of a capital nature

  - is of a private or domestic nature

  - is incurred in relation to gaining or producing exempt income a provision of the Act prevents it being deducted.

- Section 8-1(2) ITAA 97, which outlines these limitations, can be described as the negative limbs.

Nexus with income

- Section 8-1(1)(a) ITAA 97 allows for a deduction to the extent that 'it is incurred in gaining or producing your assessable income'.

- Similarly s 8-1(1)(b) ITAA 97 allows for a deduction to the extent that it is necessarily incurred in the carrying on of a business 'or the purpose of gaining or producing your assessable income.'

- There is a required connection or 'nexus' between a loss or outgoing and the production of assessable income.

    - Nexus in this case can mean a link or a connection especially a causal connection or a relation of interdependence.

    - These general phrases and has been elaborated upon by a number of court decisions – see *Re Amalgamated Zinc (de Bavay's) Ltd v FCT (1935) 54 CLR 295*.

        - Latham CJ suggested that it would be difficult to see how a loss could ever gain or produce assessable income, concluding that the section should be read as meaning 'losses or outgoings actually incurred in the course of gaining or producing… assessable income.'
        - In regard to 'outgoing', the nexus may be stated as meaning that 'the outgoing must be an expenditure which has an effect in gaining or producing assessable income'
        - A loss is not productive of anything, so it must be read as meaning 'losses and outgoings actually incurred in the course of gaining or producing the assessable income'.
        - The nexus may then be restated as requiring a connection between the expenditure and the operations or activities related to the production of income.

'Nexus' Tests

The incidental and relevant test

- The most widely quoted and accepted refinement of the statutory language is the incidental and relevant test.

- To qualify as a deduction allowable under 8.1, a loss or outgoing must be incidental or relevant to the production of assessable income.

- The test was developed in relation to s23(1)(e) of the 1922 Act, however the rules are still applicable.

Herald and Weekly Times Ltd v FCT (1932) 48 CLR 113; 2 ADT 169.	
Facts:	• The taxpayer published an evening newspaper and incurred legal fees in connection with defending an action for libel; a deduction was claimed under s23(1)(e) of the 1922 Act, but the Commissioner disallowed the claim on the grounds that it was not wholly and exclusively laid out or expended to produced assessable income as was required by s25(e) of the Act. • The Supreme Court also disallowed the amount and the taxpayer appealed to the high court.

Held:	• Majority: the expenditure was wholly and exclusively laid out for the production of income and deductible under the Act. Rich J: "As publication is the common source of income and liability the necessary connection between the carrying on of the business of the newspaper and the liability which causes the expenditure is complete." • "To establish such a deduction, it is necessary for the taxpayer to show that the expenditure is a loss or outgoing actually incurred in gaining or producing the assessable income" • "The liability to damages was incurred or the claim was encountered because of the very act of publishing the newspaper… [flowing] as a necessary or natural consequence from the inclusion of the alleged defamatory matter in the publication." • "Expenditure in which the taxpayer is repeatedly or recurrently involved in an enterprise or exertion undertaken in order to gain assessable income cannot be excluded by the Act simply because the obligation to make it is an unintended consequence which the taxpayer desired to avoid. • Minority: Starke J: The expenditure was made not for the production of income but was in fact a depletion of income incurred to pay compensation for civil wrongs. Evatt J suggested that the liability arose out of a court judgement and not in the course of gaining income.

Amalgamated Zinc (de Bavay's) Ltd v FCT (1935) 54 CLR 295.	
Facts:	• The company carried on business mining in Broken Hill. Mining ceased in 1924 and by 1929 stocks, plant and machinery were sold. The only income was derived from investments and disbursed through payments to former employees as compensation for tuberculosis. • Their liability was pursuant to a statutory scheme arising from earlier mining activities. In 1932 and 1933 the company claimed a deduction for such payments against investment income. • The Commissioner disallowed the claim on the basis that mining activities had long since ceased.
Held:	• Latham CJ suggested that it would be difficult to see how a loss could ever gain or produce assessable income. He concluded that the section should be read as meaning 'losses or outgoings actually incurred *in the course of* gaining or producing … assessable income' (emphasis added). • HC unanimously held that the payments were not deductible under the Act. In this case the outgoing sin question had no relation to the assessable income of the years in question. • "The phrase 'losses and outgoings actually incurred in gaining or producing the assessable income' may, in relation to outgoings, be read as meaning that the outgoing must be an expenditure which has an effect in gaining or producing income." • 'In order to make the section intelligible it must be read as meaning 'losses and outgoings actually incurred in the course of gaining or producing the assessable income'." • "It has been held that expenditure which has a direct relation to income of a past year can be deducted in a later assessment year when it is of such character that, in a continuing business, it must be met from time to time as part of the process of gaining income (Herald and Weekly Times v FCT), [but not where there has been a complete cessation of the income producing operations]."

The essential character test

- This test derives from *Charles Moore & Co (WA) Pty Ltd v FCT (1956) 95 CLR 344* and the *Lunney v FCT (1958) 100 CLR 478.*

- In determining the essential character of an outgoing, regard may be had to the nature of the receipt calculated to be received, but it will not be determinative. Rather, the character of the receipt requires consideration of the purpose for which a taxpayer entered into a particular contract or incurred certain expenditure (Carpark Holdings Ltd v FCT (1967)).

- There are two difficulties with the essential character test:

- As a workable non-statutory test, come criteria are required to evaluate that character; however, where a business/living distinction is not the issue is of limited application.

- The question of whether characterisation refers to an attribute of an expenditure itself or the object of an expenditure: two majority HC decisions in relation to deductibility for expenses for home offices carry a suggestion that a home has an essentially private character that is to changed by the use to which some part of it might be put (*Handley v FCT (1981); FCT v Forsyth (1981)*).

Charles Moore & Co v FCT (1956) 95 CLR 344	
Facts:	• Company employees were robbed on their way to deposit that day's takings at the Bank. It had been accepted by the courts before this case that involuntary outgoings and unforseen or unavoidable losses were allowable deductions when they were the kind of mischance or misfortune that was a natural or recognised incident of a trade or business (CT (NSW) v Ash (1937)).
Held:	• The HC said this was still the case; "incidental and relevant when used in relation to the allowability of losses as deductions do not refer to the frequency, expectedness or likelihood of their occurrence or the antecedent risk of their being incurred, but to their nature or character. What matters is their connection with operations which more directly gain or produce the assessable income." • The High Court in speaking of the meaning of the phrase 'incidental and relevant' said that the words: ○ … do not refer to the frequency, expectedness or likelihood of (the loss or outgoing) ○ … but to their nature or character. What matters is their connection with the operations which more directly gain or produce the assessable income.

Lunney v FCT (1958) 100 CLR 478	
Facts:	• Two appeals were heard concurrently in relation to claims by Lunney, and employee, and Hayley, a professional dentist. Each sought to deduct the cost of travel from their residence to their place of work.
Held:	• … To say that expenditures on fares is a prerequisite to the earning of a taxpayer's income is not to say that such expenditure is incurred in or in the course of gaining or producing his income. Whether or not it should be so characterised depends upon considerations which are concerned more with the essential character of the expenditure itself than with the fact that unless it is incurred an employee or a person pursuing a professional practice will not even begin to engage in those activities from which their respective incomes are derived. • The court considered that the travel expenses were 'at the most … a necessary

	consequence of living in one place and working in another'. • Majority: The expenditure was not deductible. ○ *"To say that expenditure on fares is a prerequisite to the earning of a taxpayer's income is not to say that such expenditure is incurred in or in the course of gaining or producing his income. Whether or not it should be so characterised depends on considerations which are concerned more with the essential character of the expenditure itself than with the fact that, unless it is incurred, an employee or a person pursuing a professional practice will not even begin to engage in those activities from which their respective incomes are derived."* • Minority: McTiernan J ○ "Without incurring fares to work, the taxpayers could not earn their assessable income and it was an unduly narrow construction of the first positive limb of the former ITAA36 51(1) to confine it to expenditure made in the bare physical and temporal limits of a workplace.

The perceived connection test

FCT v Hatchett (1971) 125 CLR 494	
Facts:	• Case of a primary school teacher who incurred expenses to obtain a higher certificate which led him to be moved to a higher pay scale and in addition incurred university fees.
Held:	• His Honour stated that 'there must be a perceived connection between the outgoing and assessable income'. The Full Federal Court in Martin v FCT (1984) 15 ATR 808 did not think that Menzies J was attempting to substitute a new test.

FCT v Anstis (2010) 241 CLR 443	
Held:	• Whilst it was determined that there was no relevant employment, the High Court held that self-education expenses incurred in satisfying the conditions of the 'Youth Allowance' were deductible.
Key notes	• Note that subsequent to this case the Government has made legislative changes to limit such deductions.

Condition of employment

- In addition to the above tests, a number of cases have looked at whether an employee's expenditure arises as a condition of employment and have denied deductions where this was not the case. On present authority, such a test does not exist, although it can still be relevant.

- If this test was employed as a prerequisite for employee deductions, it would be particularly harsh. The use of such a test would say that an employee, who for example undertakes self-education to improve his or her income production, would only gain a deduction if the employer made the expense a condition of employment. On the other hand it could be easily manipulated. Many employers might be happy to make an expense a condition of employment purely to help employees gain tax deductions.

Relaxing the temporal nexus

- As well as establishing the nexus with assessable income or carrying on a business, it is also necessary to consider which income a nexus can be linked to.

- Clearly income from the current year is relevant but can the nexus relate to future income, past income, income while a business is temporarily ceased or income from a business activity that has ended?

ACG (Advances) Ltd v FCT (1975)	
Facts:	• The taxpayer carried on a financing business until December 1968 when its operations were suspended and it entered into a scheme of compromise with creditors. • It was bought out by another business and resumed operations under a new name. • A number of debts outstanding before Dec. 1968 were written off and a deduction claimed
Held:	• Mason J: 'It is inconceivable that Parliament intended to confine deduction to losses and outgoings incurred in connection with the production of income in the year in question and to exclude losses and outgoings incurred in connection with the production of income in preceding or succeeding years.' • Barwick CJ: The decision in Amalgamated Zinc required only that, where there was a break in business activity, the resumed business must be substantially the same. Additionally, Amalgamated Zinc said nothing about losses as opposed to outgoings, and a business loss may be deductible even though it occurs in a year when a taxpayer is not actively carrying on a business.

Placer Pacific Management v FCT (1995)	
Facts:	• The taxpayer carried on a number of business activities, including manufacture of conveyor belts. A dispute arose in 1978 and, although the conveyor belt business was later sold, the taxpayer continued to be iable for claims arising out of that particular contract. The taxpayer paid damages in 1981 and legal fees which it sought to deduct under former ITAA36 s51(1).
Held:	• The Full Federal Court allowed the taxpayer's appeal, holding that the decision in AGC Advances established a proposition: o "there is no relevant distinction to be drawn between losses and outgoings. Provided the occasion for the loss or outgoing is to be found in the business operations directed to gaining or producing assessable income, the loss or outgoing will be deductible unless it is capital or of a capital nature.'

FCT v Jones [2002]	
Facts:	• A husband and wife carried on a transport business in partnership and arranged loans to finance purchase of equipment. Following the husband's death, the taxpayer struggled to clear outstanding debts and eventually refinanced the loan.
Held:	• Full FC held that the taxpayer had no free choice between continuing the loan and repaying it; refinancing the loan did not break the nexus between the interest expense and the business. • '…when an original borrowing is refinanced, the new financing takes on the same character as the original borrowing.'

FCT v Brand (1995)	
Facts:	• The taxpayer invested in a proposed prawn farming venture and paid $15,000 for the use of facilities to be constructed by NQIT, which was wound up before the taxpayer could receive a return on their investment.

Held:	• Nicholson J, FC, upheld the taxpayer's appeal against the Commissioner's denial of a deduction for the invested funds and the Full FC dismissed the Commissioner's appeal.

Steele v DCT	
Facts:	• The taxpayer was seeking new opportunities and acquired land in 1980 for development. All development options pursued were unsuccessful.
Held:	• The AAT held that interest, to the extent that it exceeded the agistment income, was directed to creating a profit-making structure and he Full Federal Court held the interest to be on capital account. A majority of the HC held that the Full FC had erred in finding that the interest was on capital account; in the usual case, interest is revenue in nature and its character is not changed because the funds are used to buy a capital asset. ○ "The temporal relationship between the incurring of an outgoing and the actual or projected receipt of income may be one of a number of facts relevant to a judgement as to whether the necessary connection might, in a given case, exist, but contemporaneity is not legally essential and whether it is factually important may depend upon the circumstances of the particular case."

Analysing s 8-1

- Establishing a nexus with assessable income or carrying on a business is central to the operation of s 8-1 but it is also necessary to consider this in the context of the whole section.

- Reading s 8-1 it first requires that there is a 'loss or outgoing' 'to the extent that'. Losses and outgoings need to be defined and the phrase 'to the extent that' raises the notion that some expenses need to be apportioned between deductible and non-deduction expenses.

Losses or Outgoings

- Most expenses deductible under 8.1 would be described as outgoings. What is meant by a loss is not so clearly understood; the sale of an item for less than its cost or the discharge of liability for more than its face value is one understanding. An involuntary loss through a fire or theft is another.

    - *Allen v Farquharson Bros (1932)*: "A loss is something different. That is not a thing he expends or disburses. That is a thing which, so to speak, comes upon him ab extra."

- Outgoings may be thought of as relating to voluntary actions on the part of the taxpayer; losses can be understood as thefts or destruction of stock (Charles Moore v FCT; Guinea Airways v FCT). It would be unnecessary to consider the question of a taxpayer's subjective purpose or motive in matters involving losses.

- It is important to remember that a strict application of the Amalgamated Zinc case might have disallowed such a deduction, but that case referred only to outgoings, and said nothing about losses, and thus in cases such as AGC Advances, amounts case be deductible losses of circulating capital (*Placer Pacific Management v FCT*).

Apportionment

- The phrase 'to the extent', that is contained in both the positive and negative limbs, has been taken to mean that mixed expenses should, if necessary, be apportioned.

- If part of an expense does satisfy the requirements but another part does not, a determination must be made as to how much relates to each.

- This is so regardless of whether the different amounts are easy to calculate or not and is to be contrasted with the treatment of mixed gains under judicial principles of ordinary income: *McLaurin v FCT (1961) 104 CLR 381, 8 ATR 180, 12 ATD 273*.

- The key case describing the methodology of apportionment is *Ronpibon Tin NL v FCT (1949) 78 CLR 47, 4 AITR 236, 8 ATD 431*.

Ronpibon Tin NL v FCT (1949)	
Facts:	• Companies carried on business of mining tin in Siam and Malaya. Income was exempt under previous provisions of ITAA36. They also derived assessable income from other investments. • Even though they lost control of the mines, they continued to seek deductions for administrative expenses, and to offset them against investment income.
Held:	• The amounts relating to mining matters were affairs of capital, not deductible under the first limb of 51(1). There was no guarantee that the mines would produce income again and the maintenance of an infrastructure was capital. Other outgoings related to exempt income. The percentage of administrative costs that were deductible were remitted to the trial judge for determination. • "there are at least two items of expenditure that require apportionment: • One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to come other cause. • It may be possible to divide expenditure in accordance with the applications which have been made of the things or services. • The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently (e.g. director's fees). • There must be some kind of fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or ratable division because it is common to both objects."

- This should be compared to the income side where in admittedly rare cases, courts sometimes said that if a lump sum mixed income and non-income items with no objective way to identify the ratio, then no part of the entire sum could be said to be assessable income: *McLaurin v FCT (1961) 104 CLR 381, 8 ATR 180, 12 ATD 273*.

- The same is certainly not true on the deduction side because of the words 'to the extent that'.

The legal basis for apportionment

- Note the legal rights basis and the purpose basis for apportionment.
- Two questions to be asked:
    - Upon what bases is the disallowable element to be identified?
        - Answer found in legal principles: If it could be demonstrated that the consideration or outlay was successful in securing legal rights (trading stock, right of occupancy) and there was no other advantage accrued for which part of the expenditure could be attributed, then there would be no basis for apportionment.

- How is the disallowable element to be apportioned?
  - A question of fact: the purposive basis, or objective purpose, for the incurring of expenditure.
  - *Magna Alloys v FCT (1980)*
    - Motive: the reason why a taxpayer decides to incur expenses
    - Subjective purpose: the object which the taxpayer intends to achieve
    - Objective purpose: The object which the incurring of the expenditure is apt to achieve.

- If income exceeds outgoings, the taxpayer's motives are largely irrelevant. If there is no assessable income or outgoings exceed income, a practical and common sense weighing up of all factors is warranted, including the taxpayer's motive (Fletcher v FCT).
- Where bona fide legal rights are acquired, the objective purpose of the expenditure is determined and it remains true to say that in those circumstances it is not for the court of the Commissioner to tell taxpayers how to manage their affairs.
- Where there is a dual purpose, expenditure is to be apportioned and there will be circumstances where purpose may mean subjective purpose or motive (Ure's case).