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## Income Overview

### Broad Rule Statement - Income

Under s14-15 of the ITAA97, Taxable income includes assessable income (s6-1) minus deductions(s8(1), 8(5)). Assessable income includes ordinary income (s6-5) and statutory income (s6-10).

### Ordinary Income

Ordinary income includes income according to ordinary concepts (s 6-5, *Scott v FCT*), and has been judicially developed to cover three main categories: income from services, income from business, and income from property.

### Statutory Income

Specific amounts legislated as taxable income, even if they do not fit the ordinary concept of income. (*Section 6-10*).

**Exempt income** (s 6-20, Div 11, Pt 2-15) is income specifically excluded from the tax base by statute (e.g. certain government pensions, income of tax-exempt bodies, some foreign income). While not taxed, exempt income is relevant for certain tax attributes, such as reducing the amount of carried-forward tax losses under Div 36.

**Non-assessable non-exempt (NANE) income** (s 6-23) refers to amounts that are entirely excluded from both assessable and exempt income categories. NANE income is not taxed and does not affect tax losses or other tax attributes. Examples include the GST component of income (s 17-5), certain fringe benefits (under FBT), and some government grants specifically made NANE by statute.

### Nuance:

- If an amount falls under an exempt or NANE provision, it will not be assessable, even if it otherwise meets the definition of ordinary income (s 6-5) or is specifically included as statutory income (s 6-10).
- Exempt income reduces tax losses; NANE income does not.

## Income Tax rates 1986 - Schedule 7 (subsection 12(1)) -

Tax rates for resident taxpayers for the 2024 - 25 year of income or a later year of income		
Item	For the part of the ordinary taxable income of the taxpayer that:	The rate is:
1	exceeds the tax - free threshold but does not exceed \$45,000	16%
2	exceeds \$45,000 but does not exceed \$135,000	30%
3	exceeds \$135,000 but does not exceed \$190,000	37%
4	exceeds \$190,000	45%

### Basic income tax calculation

- Step 1: assessable income = ordinary income + stat. income  
[excl. exempt income and non-assessable non-exempt income]  
ss 6-5, 6-10, 6-15
- Step 2: deductions = general + specific deductions, ss 8-1, 8-5
- Step 3: taxable income = assessable income – deductions, s4-15
- Step 4: income tax on “taxable income”, s4-10
- Step 5: tax offsets, s13-1 (list)
- Step 6: income tax = (taxable income x rate) - tax offsets, s4-10(3)

### Key questions in income taxation include:

1. Who is the relevant taxpayer?
  - Federal coke case
2. When is income derived?
  - Brent
3. What is the amount of income?
  - Constable
4. Does the taxpayer derive it and own it beneficially?
  - Zobory, Countess of Bectives

## CGT Event C2: The ending of an intangible CGT asset (such as a contractual right)

### Overview

**CGT Event C2** occurs when ownership of an **intangible CGT asset** ends, including by redemption or cancellation (e.g., shares, debentures), release, discharge or satisfaction (debts), expiry, abandonment, surrender, or forfeiture of contractual rights (s 104-25(1)).

### Timing

The timing is when the contract ending the asset is entered, or, if no contract, when the asset ends (s 104-25(4)).

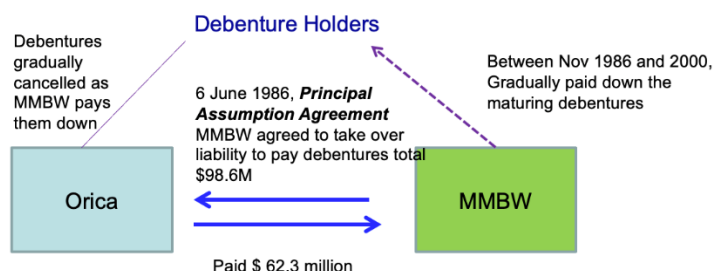
### Calculation

The **capital proceeds** are the amount received on ending the asset, and the capital gain or loss is calculated as proceeds less the asset's cost base.

In *Orica Ltd v FCT*, the High Court held that each incremental "pay down" of debentures under a defeasance contract triggered a separate C2 event, and gains were realised pro rata as each right ended.

### Orica

#### Background and Facts



1987 tax assessment: Included \$8 million as a taxable capital gain in respect of the debt defeasance transactions for the debentures cancelled in that fiscal year

- Orica (the taxpayer) had **issued debentures** (a form of borrowing from the public).
- A **trust deed** imposed restrictive business covenants (ratios and restrictions) to protect debenture holders.
- Over time, these restrictions became commercially **burdensome** for Orica's business operations.
- Instead of buying back debentures (impractical because of wide ownership), Orica engaged in an **"in-substance debt defeasance"**:
  - Paid **\$62.3 million** to the **Melbourne and Metropolitan Board of Works (MMBW)** and the **State Bank of NSW**.
  - In return, **MMBW and the Bank agreed to make the required payments** (interest and principal) to debenture holders.
- **Result:** Orica was practically freed from debenture obligations even though legal obligations remained with MMBW and the Bank.

#### ATO's Argument

- The **profit** (the difference between the \$98.6m face value and the \$62.3m paid) should be taxed:
  - Either as **ordinary income** immediately under **Myer Emporium principles**; or
  - Over time under **Division 16E** of the ITAA 1936.

#### Orica's Argument

- The profit **was not ordinary income**.
- Alternatively, if CGT applied, any gain arose **only when MMBW actually performed** (i.e., made payments to debenture holders).

#### Issues for the High Court

1. Was there an **"asset"** acquired under CGT rules?
2. Was there a **"disposal"** of that asset when MMBW performed its obligations?

#### Held – Decision

The **High Court** ruled in favour of the Commissioner partially:

- **Not ordinary income** in 1986.
- **But CGT liability arose over time** as MMBW made payments under the assumption agreement.

#### Reasoning

In *Orica*, CGT was triggered by the gradual discharge of contractual rights under s 160M(3)(b), which today would be CGT Event C2 — the ending of an asset.

##### (a) Was there an "Asset"?

- **Yes**, Orica acquired **enforceable rights** against MMBW under the Principal Assumption Agreement.
- **Definition of asset (s 160A):** Very broad — includes **any property, debts, choses in action, and other rights**.
- Even if rights are personal and not easily assignable, they **still qualify as an asset**.

- The rights to compel MMBW to pay were **valuable and enforceable**, and debenture holders would clearly have an interest in their enforcement.

**(b) Was there a "Disposal" of the Asset?**

- **Yes**, under s 160M(3)(b) of ITAA 1936:
  - A disposal occurs when a right is **discharged, satisfied, or extinguished**.
- Each **payment by MMBW** on the debentures **discharged part** of Orica's rights under the assumption agreement.
- The High Court rejected the argument that "discharge" or "satisfaction" must occur outside normal performance of obligations:
  - **Performance itself can constitute discharge**.
- Thus, **each time MMBW paid debenture holders**, a **partial disposal** of Orica's asset (its rights) occurred.

## CGT Event D1: creating rights in another person

### Overview

**CGT Event D1** happens when a taxpayer creates a legal or equitable right in another person (s 104-35(1)). This event applies to the grant of licences (e.g., licensing IP), restrictive covenants (e.g., non-compete agreements), or options, and does not require the disposal of a pre-existing asset.

- D1 **DOES NOT** apply where the **right is created by borrowing money, obliges the taxpayer to dispose of an existing asset (A1 applies instead), or relates to the issue of shares or similar interests**.

### D1 and non competes

Where a person receives payment for creating an enforceable right (such as a non-compete, as in *Phillips v FCT*), D1 is triggered: a new contractual right has been created for the other party, and any payment received constitutes the capital proceeds.

Case	Key Point
<b>Phillips</b>	<ul style="list-style-type: none"> <li>• The taxpayer entered into a <b>non-compete agreement</b> — they agreed <b>not to engage in a competing business</b>.</li> <li>• They received <b>payment</b> for agreeing to this restriction.</li> </ul> <p><b>How D1 applied:</b></p> <ul style="list-style-type: none"> <li>• <b>By promising not to compete</b>, the taxpayer <b>created a new legal right</b> in favor of the other party — the right to stop Phillips from competing.</li> <li>• <b>This is exactly what CGT Event D1 targets:</b> the creation of enforceable rights.</li> <li>• The <b>payment</b> received is the <b>capital proceeds</b>.</li> </ul> <p><b>Why D1?</b> A new enforceable right (the right to restrict competition) was created, and money was paid for that promise.</p>
<b>Higgs v Olivier</b>	<ul style="list-style-type: none"> <li>• Famous actor Sir Laurence Olivier agreed <b>not to act for other film companies</b> during a certain period.</li> <li>• He received a <b>large payment</b> for entering into this restrictive agreement.</li> </ul> <p><b>How D1 applied:</b></p> <ul style="list-style-type: none"> <li>• Even though it's a UK case, the principle is similar:           <ul style="list-style-type: none"> <li>○ Olivier <b>created a right</b> for the production company — the right to his exclusive services (and his restraint from acting elsewhere).</li> </ul> </li> <li>• If applying Australian CGT law, this would <b>trigger CGT Event D1</b> because:           <ul style="list-style-type: none"> <li>○ <b>A legal right was created</b> (enforceable exclusivity).</li> <li>○ Payment was made for that right.</li> </ul> </li> </ul> <p><b>Why D1?</b> Olivier's agreement not to act elsewhere created a valuable contractual right benefiting the production company — fitting the D1 model perfectly.</p>
<b>Woite</b>	Involved sports agreements where restrictions on future behavior (e.g., playing for certain clubs) created rights that were valuable.
<b>Dickenson</b>	Further example of restrictive covenants where compensation for agreeing not to do something triggered tax consequences.

### Calculation

The capital gain is calculated as the **capital proceeds** (amount received) **less incidental costs** (e.g., legal fees) directly related to the event; there is no cost base for the right itself, as it is created, not acquired (s 104-35(3)). If incidental costs exceed proceeds, a capital loss arises.

- **Timing** is at contract or creation of the right (s 104-35(2)).
- The CGT discount and indexation are **not available** for D1 (s 115-25(3)); *Hepples v FCT* (1990) 22 FCR 1 confirms the strict application of D1 to restrictive covenants and similar arrangements.

*Other CGT events are specific to a particular kind of transaction, eg CGT on lease premiums and other lease-related dealings (Events F1-F3) or CGT events relating to trusts (Events E1-E8). There is a residual CGT event H2 which is a 'catch all' for some gains.*

### Hepples

#### Procedural History:

- This case addresses the interpretation and application of the controversial s 160M(6) and (7) of the ITAA 1936, known as the "terrible twins" due to their complex and often criticized deeming provisions for capital gains tax.

#### Facts:

- The taxpayer received a payment under a restrictive covenant agreement. The issue was whether this payment triggered a capital gains tax liability under the provisions of s 160M(6) and/or s 160M(7) of the ITAA 1936, which concern the deemed disposal of assets.

#### Legal Issue(s):

- Whether the payment for entering into a restrictive covenant constitutes a "disposal" of an asset under s 160M(6) or s 160M(7), thereby rendering the gain taxable under the CGT provisions of the ITAA 1936.

#### Decision:

- The High Court found that the gain was assessable under either s 160M(6) or s 160M(7). However, there was no clear majority for either provision alone, leading to a nuanced interpretation by the judges.

#### Reasoning:

1. **Complexity of Provisions:** The court noted the complexity and the broad scope of the "terrible twins," which aim to tax gains from non-physical transactions or rights changes that do not involve straightforward disposals of physical assets.
2. **Application to Restrictive Covenants:** The court grappled with whether the restrictive covenant was an asset created at the time of the agreement and whether entering into the covenant amounted to a disposal of that asset.
3. **Judicial Interpretation:** The judges provided diverse opinions on the application of the provisions, reflecting the inherent ambiguities and the broad deeming capabilities of the sections. The majority view was that the provisions could apply, but there was significant debate over the specific application to the facts of the case.

#### Legal Principles:

- **Deemed Disposal:** s 160M(6) applies to the creation of new assets through transactions, while s 160M(7) deals with gains derived from acts, transactions, or events affecting existing assets. These sections expand the CGT regime's reach to include non-traditional disposals.
- **Asset Definition:** The interpretation of what constitutes an asset in these contexts is critical, with implications for a wide range of legal and commercial arrangements beyond straightforward sales or transfers of physical property.

#### Commentary:

- This decision highlights the challenges in applying CGT provisions to modern commercial and employment transactions, particularly where payments are made for rights or non-physical benefits. The case underscores the need for clear legislative definitions and guidelines to reduce uncertainty and litigation regarding CGT liabilities.
- The High Court's decision led to legislative changes aimed at clarifying these provisions. The subsequent amendments to s 160M(6) and (7) and their encapsulation in the newer ITAA 1997 attempt to address some of the criticisms and confusions evidenced in this case.

## CGT Exemptions: Div 118

### Cars and Motor Cycles

A capital gain or loss made from a *car*, *motor cycle*, or similar vehicle is **disregarded for CGT purposes** (s 118-5(1)).

- "Car" is defined as a motor vehicle designed to carry a load of less than one tonne and fewer than nine passengers.

### Main Residence

A capital gain or loss arising from a CGT event relating to a taxpayer's *main residence* is **disregarded** if the dwelling was the taxpayer's main residence throughout the ownership period and was not used to produce assessable income (ss 118-110, 118-115, 118-120, 118-130 ITAA 1997).

- Adjacent land up to 2 hectares may also be included (s 118-120).
- Partial exemption applies if only part of the period was main residence, or if partially income-producing (s 118-185, s 118-190).
- Absence rule: may continue to treat as main residence during absences (up to 6 years, s 118-145).

### Damages and Compensation Payments for Personal Injury

A capital gain or loss made from a CGT event relating directly to *compensation or damages received for any wrong, injury or illness suffered personally by a taxpayer* (or a relative) is **disregarded** (s 118-37).

### Prizes and Gambling Winnings

Gains from *prizes* (e.g. lottery, game show) and *gambling winnings* are **not subject to CGT** as they are not considered CGT assets under s 108-5 and are not ordinary income unless received as part of carrying on a business.

### Trading Stock

*Trading stock* is expressly excluded from the CGT regime (s 118-25).

- Gains and losses on trading stock are dealt with under the ordinary income and deductions provisions, not CGT.

### Depreciating Assets

A capital gain or loss from a *depreciating asset* is **disregarded** to the extent the asset was used for a *taxable purpose* (e.g. income producing) (s 118-24(1)).

- However, if a depreciating asset is used *solely for a non-taxable purpose* (e.g. private use), CGT may apply (see s 118-24(2), s 40-300).

## Roll-overs

### Divorce: Rollover on Marriage/Relationship Breakdown (Div 126)

Rollover relief under Division 126 applies where a CGT asset is transferred between spouses (or former spouses) as a result of a marriage or de facto relationship breakdown, pursuant to a court order, binding financial agreement, or prescribed instrument (s 126-5). The transfer does not trigger a CGT event for the transferor. Instead, the transferee spouse is taken to acquire the asset at the transferor's cost base and on the same acquisition date. Any capital gain or loss is deferred until the transferee subsequently disposes of the asset.

### Inheritance on Death (Div 128)

No CGT event arises on the death of an individual (s 128-10). When an asset passes to a legal personal representative or beneficiary, the beneficiary inherits the asset with a cost base generally equal to the deceased's cost base for post-CGT assets or the asset's market value at death for pre-CGT assets (s 128-15(4)). The main residence exemption may apply if the inherited

dwelling is disposed of within two years (s 118-195). The beneficiary may also access the CGT discount if the combined holding period is at least 12 months (s 115-30(1) Item 4).

### **Business Incorporation Rollover (Div 122-A)**

Division 122-A provides rollover relief where individuals, partnerships, or trusts transfer assets to a company on business incorporation. Any capital gain or loss from the transfer is disregarded (s 122-50). The company acquires the asset with the transferor's cost base and acquisition date (s 122-70), provided all business assets are transferred, shares are issued to the transferor, and the same underlying ownership is maintained.

### **Takeovers and Mergers: Scrip-for-Scrip Rollover (Div 124-M)**

Scrip-for-scrip rollover under Division 124-M applies when a taxpayer exchanges shares or units in one company or trust for shares or units in another company or trust during a takeover, merger, or restructure. Any capital gain or loss is disregarded (s 124-780). The new shares or units are taken to have the same cost base and acquisition date as the original interests (s 124-785), provided eligibility requirements are met.

### **Renewal of Statutory Licences**

Where a statutory licence (e.g., taxi or liquor licence) is renewed or replaced and economic ownership is unchanged, a rollover is available under s 124-10 and relevant ATO guidance. The renewal or replacement is not treated as a CGT event. The taxpayer's cost base and acquisition date are transferred to the new licence, preventing immediate CGT liability.

### **Replacement of Business Depreciating Assets (Div 40)**

Where a depreciating asset used for business is involuntarily lost or destroyed, rollover relief may apply to disregard any balancing adjustment event, provided a replacement asset is acquired (ss 40-365 to 40-370). The new asset's cost and tax attributes are adjusted, and immediate CGT is avoided. This typically covers cases involving compulsory acquisition, destruction, or loss.

## **CGT Discount**

A taxpayer may reduce a capital gain by the CGT discount if:

- The taxpayer is an individual, trust, or complying superannuation fund (not a company) (s 115-10);
- The CGT event giving rise to the gain occurred after 11:45 am, 21 September 1999 (s 115-15);
- The asset was owned by the taxpayer for at least 12 months before the CGT event (s 115-25(1));
- The CGT event is not excluded by s 115-25(3) (for example, events D1, D2, D3, E9, F1, F2, F5, H2, J2, J5, J6, K10); If these conditions are satisfied, the assessable gain is reduced by 50% for individuals and trusts, or 33⅓% for complying superannuation funds (s 115-100).

**For assets acquired before 21 September 1999 and sold after, the taxpayer may choose either to apply indexation of the cost base (frozen at 21 September 1999: Div 114; s 110-25(7)), or the discount, but not both (s 115-20, s 102-3).**

### **Indexation Rule Statement**

Where a CGT asset was acquired before 21 September 1999, the taxpayer may choose to apply indexation to the cost base for inflation up to 21 September 1999 (Div 114, s 110-25(7)-(8)). Indexation does **not** apply to capital losses or the reduced cost base and is not available if the CGT discount is applied (s 115-20).

### **Mechanisms for Reconciliation**

#### **1. Subtraction Method:**

- The primary mechanism used in the ITAA 1997 for reconciling ordinary income and CGT is subtraction, particularly outlined in s 118-20. This section effectively reduces the capital gain by any amount that is included in a taxpayer's assessable or exempt income. The purpose is to adjust the CGT calculation by the amount that has already been captured as ordinary income or exempt income, thus avoiding double taxation.
- Subsection 118-20(4) extends this adjustment to amounts that are considered "neither assessable income nor exempt income," ensuring that these amounts do not lead to CGT liabilities.

## **6. Deductions**

A taxpayer may deduct from assessable income any loss or outgoing to the extent that it is **incurred in gaining or producing assessable income** or is **necessarily incurred in carrying on a business** for that purpose (s 8-1(1)). However, a deduction is **not** available to the extent that the loss or outgoing is **capital, private or domestic in nature, relates to earning exempt or non-assessable non-exempt income**, or is **expressly denied elsewhere in the Act (s 8-1(2))**. These are known as **general deductions** (s 8-1(3)).

In addition, a taxpayer can claim **specific deductions** where allowed by another provision of the Act outside Div 8 (s 8-5). Where more than one provision permits a deduction for the same amount, only the most appropriate provision applies (s 8-10).

### **1. First Positive Limb: "Incurred in gaining or producing assessable income"**

A deduction is available under the first limb of s 8-1 ITAA 1997 for a loss or outgoing to the extent that it is "incurred in gaining or producing assessable income". To satisfy this limb, there must be a real and sufficient nexus between the outgoing and the derivation of assessable income meaning that the outgoing must be "incidental and relevant" to the income-earning activity, and not merely remote, preparatory, or referable to a past or ceased business. (*Ronpibon Tin; Herald & Weekly Times; Charles Moore*).

If an outgoing serves both income-producing and other purposes, s 8-1 requires apportionment on a fair and reasonable basis (*Ronpibon Tin; Ure v FCT* (1981) 50 FLR 219).

### **Nuances and Application in Case Law**

**"In the course of" income production – Real Nexus**



- The expense must be genuinely connected to the process of deriving assessable income—not merely a causal or temporal connection. (*Ronpibon Tin*)
  - **Application:** Outgoings must be “incidental and relevant” to income production, not too remote. For example, management expenses partly relating to earning exempt income must be apportioned.

#### Outgoings as ordinary risks of business

- Expenses arising as a natural and expected incident of business are deductible. (*Herald & Weekly Times*; *Charles Moore*)
  - **Application:**
    - *Herald & Weekly Times*: Settlement and legal costs for defamation were deductible because such risks are inherent in newspaper publishing.
    - *Charles Moore*: Loss from theft of business takings was deductible as it arose during a necessary business activity (banking cash).

#### Expenses arising from income-earning activities, not personal or private matters

- Legal or other costs incurred to protect or maintain a source of assessable income are deductible, but not if they are private or have lost their connection to current income-earning. (*FCT v Day*; *FCT v Anstis*; *Amalgamated Zinc*)
  - **Application:**
    - *Day*: Legal expenses defending employment-related charges were deductible as they were directly tied to continued employment income.
    - *Anstis*: Self-education expenses were deductible as they were incurred to retain Youth Allowance.
    - *Amalgamated Zinc*: Ongoing compensation liabilities after the business ceased were not deductible—nexus with current income broken.

#### No strict contemporaneity required

- Expenses incurred before or after income is earned can be deductible if linked to income production (no strict matching required). (*Finn*; *Steele*; *AGC (Advances)*; *Placer Pacific*)
  - **Application:**
    - *Finn*: Future-oriented study tour expenses were deductible as they aimed at future income.
    - *Steele*: Pre-income interest outgoings for acquiring business assets deductible if committed to future income use.
    - *AGC (Advances)*: Temporary business suspension did not break the nexus.
    - *Placer Pacific*: Product liability claim after sale of business deductible as it arose from prior operations.

#### 5. Apportionment for mixed-purpose expenses

- Outgoings only partly related to income production must be apportioned on a “fair and reasonable” basis. (*Ronpibon Tin*; *Ure*)
  - **Application:**
    - *Ronpibon Tin*: General administration expenses relating to both exempt and assessable income required apportionment.
    - *Ure*: Interest on a loan split between investment and private purposes was only deductible to the income-producing extent.

#### 6. Expenses for professional services and contracts

- Recurrent costs directly connected to earning assessable income are deductible; costs for acquiring structural capital are not (*Spriggs v FCT*; contrast *FCT v Maddalena*)
  - **Application:**
    - *Spriggs*: Management fees for negotiating sporting contracts are deductible as they were part of the ongoing business of professional athletes.

Case (Short Name)	Facts	Issue	Decision
<b>Ronpibon Tin</b>	Mining companies earned both assessable (interest) and exempt (overseas) income; claimed deduction for general expenses.	Can expenses relating to both exempt and assessable income be deducted?	Deductions allowed only to the extent expenses are “incidental and relevant” to assessable income; required fair and reasonable apportionment.
<b>Herald &amp; Weekly Times</b>	Newspaper publisher paid damages and legal costs to settle defamation claims arising from publication.	Are defamation-related legal and settlement costs deductible under the first limb?	Yes; expenses were a normal business risk, “incidental and relevant” to income production.
<b>Charles Moore</b>	Department store’s daily cash takings stolen en route to the bank.	Is a loss from theft of business cash deductible?	Yes; loss arose in the ordinary course of business operations and was deductible.
<b>Amalgamated Zinc</b>	Mining business ceased; company later incurred compensation liabilities for former workers.	Are compensation payments after business ceased deductible?	No; expense not connected to current income production, nexus broken.
<b>Day</b>	Customs officer incurred legal expenses defending disciplinary charges related to employment.	Are legal expenses incurred in defending job-related charges deductible?	Yes; expenses directly related to income-earning activities of employment.
<b>Anstis</b>	Student claimed self-education expenses to retain Youth Allowance (statutory income).	Are self-education expenses to retain an assessable government benefit deductible?	Yes, expenses were incurred in gaining/producing an assessable income (they youth allowance) – - HOWEVER – s 26-19 denies self-education expenses incurred to obtain government benefit payments such as youth allowance.

<b>Finn</b>	Trade commissioner incurred study tour expenses to improve future professional performance.	Can expenses incurred for future income-earning activities be deducted now?	Yes; future-oriented outgoings may be deductible if genuinely linked to income production.
<b>Steele</b>	Interest incurred on borrowed funds to acquire land intended for future income production.	Is interest deductible when income has not yet commenced?	Yes, if taxpayer has a genuine and committed income-producing purpose.
<b>Spriggs</b>	Professional athletes paid agent fees to negotiate contracts and endorsements.	Are agent fees to secure new contracts deductible for athletes in business?	Yes; recurring expenses integral to ongoing income-earning business are deductible.
<b>Ure</b>	Borrowed funds partly used for income and partly private purposes; interest claimed in full.	Can interest on mixed-purpose loans be fully deducted?	No; only the portion relating to income production is deductible—requires apportionment.
<b>AGC (Advances)</b>	Finance business temporarily suspended, later resumed; claimed deduction for pre-suspension losses.	Does business suspension break the nexus for deducting later losses?	No; deduction allowed as business continuity remained substantially intact.
<b>Placer Pacific</b>	Business sold; post-sale, company incurred liability for defective products supplied pre-sale.	Are post-cessation liabilities from prior business deductible?	Yes; deductible if liability originates from past income-producing operations.

## 2. Second Positive Limb – Necessarily incurred in carrying on a business

Under the second limb of s 8-1 ITAA 1997, a business taxpayer may deduct a loss or outgoing to the extent that it is “necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.” The word “necessarily” is interpreted to mean that the expense must be “appropriate and adapted” to the business’s income-earning activities, not that it is strictly unavoidable or legally compelled (*Magna Alloys*).

- The core inquiry is whether the outgoing was reasonably incurred as part of ordinary business operations, with respect given to commercial context and the taxpayer’s business judgment (*Magna Alloys*; *Snowden & Willson*).
- Expenses are deductible if they **serve to protect or advance the ongoing conduct or reputation of the business**, such as legal or advertising costs defending the business’s viability (*Snowden & Willson*),
  - or outgoings aimed at **reducing revenue costs or improving efficiency**, like lump sum payments to end management contracts (*W Nevill*). Expenses for business losses arising in the ordinary course, even if involuntary or unexpected, may also be deductible if sufficiently connected to business operations (*Charles Moore*).
  - This includes some costs incurred in anticipation of future income, provided they are genuinely referable to a committed business purpose (*Steele (1999) 197 CLR 459*).

### “Necessarily incurred” = “Appropriate and adapted” (not strictly necessary or unavoidable)

- The test is not whether the outgoing was strictly required or compulsory, but whether it was commercially appropriate and adapted to further the business’s income-earning purpose. (*Magna Alloys*)
  - **Application:**
    - The taxpayer’s legal costs defending its directors (for criminal charges linked to business activities) were deductible as the company’s business reputation was at stake. The court gave weight to the business’s judgment about what expenditures are necessary for carrying on its operations.
    - **Key quote:** “Necessarily incurred” means “appropriate and adapted” to achieving the business’s objectives (*Magna Alloys* per Deane and Fisher JJ).

### Commercial context and business judgment

- The courts respect business judgment where a reasonable businessperson would regard the outgoing as appropriate for the business, even if not strictly necessary for every business in the same field. (*Magna Alloys*; *Snowden & Willson*)
  - **Application:**
    - *Magna Alloys*: Company’s payment of legal costs was reasonable to protect the business, even though not strictly required by law.
    - *Snowden & Willson*: Legal and advertising costs to defend business reputation before a Royal Commission were deductible; defending the business’s viability and goodwill was a rational and instinctive response in the business context.

### Broad scope: Outgoings incurred for the business’s ongoing conduct, protection, or efficiency

- Expenses that are commercially sensible steps to protect, promote, or efficiently operate the business—even if not linked to a particular item of income—can be deductible. (*W Nevill*; *Snowden & Willson*; *Magna Alloys*)
  - **Application:**
    - *W Nevill*: Lump sum payment to terminate a managing director’s contract was deductible; the payment was made to reduce ongoing costs and improve operational efficiency, both regarded as legitimate business purposes.
    - *Snowden & Willson*: Distinction drawn between defending the business (deductible) and paying penalties for illegal acts (not deductible).

### Not all “business-related” expenses qualify—must be connected to business purpose

- The outgoing must be **genuinely** referable to the conduct of the business, not to personal, capital, or private matters. (*Magna Alloys*; *W Nevill* (cf. negative limb cases))
  - **Application:**