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John Passant

University of Wollongong

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Abstract

This article examines the basic judicial principles used in interpreting s51(1) of the Income Tax Assessment Act 1936, the general deduction provision in the Act. It then looks at the application of those principles to the deductibility or otherwise of university fees.*

Keywords

income tax assessment, tax, university fees

Cover Page Footnote

My thanks go to Hugh Selby from the Legal Workshop at the ANU for his helpful comments.

A CROOKED JOURNEY THROUGH THE MAZE? OR: UNIVERSITY FEES AS SELF-EDUCATION EXPENSES

John Passant
Lecturer
Faculty of Law
University of Wollongong

This article examines the basic judicial principles used in interpreting s 51(1) of the Income Tax Assessment Act 1936, the general deduction provision in the Act. It then looks at the application of those principles to the deductibility or otherwise of university fees.*

The deductibility of self-education expenses is in the main determined under the general deduction provision, s 51(1) of the Income Tax Assessment Act 1936.¹ Under s 82A the first \$250 of such expenditure is not deductible where the expenses relate to a course of education offered by a school, college, university or other place of education.

This article looks at the tax deductibility of university fees under s 51(1). In particular it examines the deductibility of large up-front fees of the type imposed by universities on legal workshop students. Legal workshop is the "postgraduate" course in practical legal training which enables law students to be admitted as barristers and solicitors and thus practise.

As the push for Universities to impose fees gathers pace, the question of the tax treatment of such fees will become more and more

* My thanks go to Hugh Selby from the Legal Workshop at the ANU for his helpful comments.

¹ Section 54 allows a depreciation deduction for plant or articles used for the purpose of producing assessable income. Everyone assumes this allows depreciation on items such as personal computers used for self-education purposes, but I am not sure.

important for an increasing number of students. For that reason it is first necessary to look at s 51(1) and its judicial interpretation.

Some general comments on s 51(1)

The relevant part of s 51(1) reads:

All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income ... shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

It is difficult to understand the provision and many of the cases and commentary on it. It is a bit like watching a foreign film, in a language you cannot understand, without subtitles. You know something is going on, but you are not quite sure what.

The concept behind s 51(1) seems simple enough. To make money you have got to spend money, and if there is a sufficient relationship between the expenditure and the income earning activity then the expenditure will be allowable, assuming the negative limbs of the provision do not apply. As Grbich puts it; "the core concept [contained in s 51(1)] is unusually clear. It directs that an expenditure can only be deducted if it was spent to earn assessable income".²

The real issue is what is the nexus between the expenditure and the income which makes it allowable?

But first, one clarification. As the courts have pointed out, losses and outgoings are not incurred in gaining or producing assessable income; rather they are incurred *in the course* of gaining or producing assessable income and the provision has been interpreted accordingly.³

The judiciary has developed a number of differing tests for determining the application of s 51(1) in particular circumstances. It

² Yuri Grbich, "Revisiting the Main Deduction Provision: Clear Concepts for a Mass Decision-Making System" (1990) 17 MULR 347 at 347. As we shall see, even this is not adequate, because some allowable expenditure does not earn assessable income; rather it arises as a consequence of earning assessable income.

³ See *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 295 at 309 per Dixon J and *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 56.

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is worthwhile recalling the words of Mr Justice Dixon (as he then was) in *Robert G Nall v FCT*⁴ where his Honour said:⁵

Courts cannot ascribe to legislative provisions a more exact and logical meaning than is to be found in them and it is dangerous to attempt to do so. For indefiniteness in a statutory criterion is not always unintentional. It is, therefore, unwise to undertake to say what in every case shall be and what shall not be enough to bring a payment within the general scope of the provision to qualify it as an allowable deduction.

Despite this warning, a number of phrases have earned almost delphic significance in explaining the operation of s 51(1), more I might say as a consequence of their constant repetition than for anything especially enlightening contained in them.

Tests for deductibility

In *Ronpibon Tin NL v FCT*⁶ the Court said that, "for the expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end".⁷ The phrase "incidental and relevant" lacks clarity, but that does not stop tax practitioners and students regurgitating it.

In *Lunney v FCT*⁸ the High Court developed the "essential character" test as a qualification to the incidental and relevant test. Indeed Williams, Kitto and Taylor JJ thought that "the expression 'incidental and relevant' was not used [in *Ronpibon Tin*] in an attempt to formulate an exclusive and exhaustive test for ascertaining the extent of the operation of the section".⁹ This was said in the context of a taxpayer's attempt in *Lunney* to claim fares to and from work as a deduction. Arguably, being a prerequisite for earning assessable income, they were incidental and relevant under the *Ronpibon* test. However the whole history of the interpretation of s 51(1) up to that date had been to reject the deductibility of fares to and from work. For that reason Williams, Kitto and Taylor JJ qualified the incidental and relevant test. They said:¹⁰

⁴ (1937) 57 CLR 695.

⁵ Ibid at 712.

⁶ (1949) 78 CLR 47 at 56.

⁷ Ibid.

⁸ (1958) 100 CLR 478.

⁹ Ibid at 497.

¹⁰ Ibid at 499.

But 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 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 these activities from which their respective incomes are derived.

As a guide to determining the deductibility of expenditure, the essential character test is singularly useless. "What does the phrase actually mean?" I ask my students. Their answers almost always suggest that there is some essential element in a particular type of expenditure which makes it deductible or not, as the case may be. This seems to imply that, no matter what the circumstances, some expenditure will be of such a character that it will not be deductible. This, of course, cannot be the case. In some circumstances certain expenditure will be deductible, but in others it will not. In other words, the character of the expenditure has to be judged in the context of the circumstances of the particular taxpayer claiming the deduction. So, to talk of the essential character of expenditure is at best misleading and at worst meaningless.

Perhaps a more prosaic explanation might be that the phrase means that for an expenditure to be deductible it must have the essential character of a business or work expense. As Williams, Kitto and Taylor JJ also said, in relation to the cost of fares to and from work:¹¹

Expenditure of this character is not by any process of reasoning a business expense; indeed, it possesses no attribute whatever capable of giving it the colour of a business expense. Nor can it be said to be incurred in gaining or producing a taxpayer's assessable income.

This analysis is hardly earth-shattering, and tells us nothing at all about the application of the provision. More recent cases have married the incidental and relevant test with the essential character test. For example, Lockhart J in *FCT v Cooper*¹² said:¹³

For expenditure to be an allowable deduction as an outgoing incurred in gaining or producing the assessable income, it must be incidental and relevant to that end ...This test of deductibility has been explained in

¹¹ Ibid at 501.

¹² 91 ATC 4396.

¹³ Ibid at 4400.

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subsequent judgments of the High Court, so that to be deductible the expenditure must be incidental and relevant in the sense of having the essential character of expenditure incurred in the course of gaining or producing assessable income.

Hill J in the same case said, in relation to the *Lunney* decision:¹⁴

[The case] emphasises that the question of deductibility has to be decided by reference to the essential character of the expenditure. The essential character of expenditure on travel to and from work is not that of a business or working expense, and for that reason the claim to deductibility must fail.

The end result of the approach of these two judges in *Cooper* was that additional expenditure by a footballer on food and alcohol to beef himself up to retain or regain his first grade spot was held not to be allowable. Its essential character as food and drink was neither incidental nor relevant to his training and playing as a footballer.¹⁵

Wilcox J dissented in *Cooper* and would have allowed a deduction. His Honour pointed out that the essential character test "tends to beg the critical question".¹⁶ As he said:¹⁷

Everything depends upon the ambit of the facts selected for inclusion in the description of essential character; so that the making of that selection predetermines the outcome of the case ... If one characterises Mr Cooper's expenditure merely as food and drink, there is no nexus with the earning of assessable income; the claim must fail. If, on the other hand, the occasion of the expenditure is considered, it is seen as being for the additional food and drink necessary to maintain an optimum playing weight, and so safeguard the respondent's First Grade status and earnings. The nexus with assessable income becomes clear.

There does appear to be some sort of connection between playing first grade rugby league as a forward and bulking up. "Extra" food is just one way among a number by which this can occur. Whether the relationship between the expenditure and earning income is sufficiently proximate is the real question. On this point Wilcox J was in the minority. Lockhart J said: "The taxpayer was paid money to train for and play football, not to consume food and drink. His

¹⁴ Ibid at 4413.

¹⁵ Ibid at 4403 per Lockhart J.

¹⁶ Ibid at 4404.

¹⁷ Ibid.

income producing activities did not include the consumption of food or drink".¹⁸

This does not deal adequately with the issue. It is certainly true that the taxpayer was not paid to consume food and drink. Neither was he paid to join the Rugby League professional footballers' union, yet that membership payment would in all likelihood be an allowable deduction. Another way of putting it is that the process of training included the consumption of extra food and drink. Indeed, the whole point about the taxpayer's argument was that the consumption of "extra" food and drink enabled him to earn more money as a footballer. Just as expenditure by the footballing taxpayer on a weights machine at home would presumably be deductible or depreciable because it is spent in the course of earning or producing assessable income, so too, arguably, could be the expenditure on "extra" food.

The logic of Lockhart J's approach outlined above would also see expenditure on food and accommodation by travelling business people disallowed. After all, business people are not paid to consume food or use accommodation; they are paid to conduct business.¹⁹

If anything, *Cooper* shows that the judicial approach to the interpretation of s 51(1) might best be described as being that the expenditure must be incidental and relevant in the sense of having the essential character of expenditure incurred in the course of gaining or producing assessable income. On the other hand, the consistent application of this nostrum, as *Cooper* shows, is difficult in the extreme.

More recent cases highlight what appears to be the expanding application of the provision to allow deductions for items which seem to be personal and private.

In *FCT v Edwards*,²⁰ the taxpayer was the personal secretary to the wife of the Queensland Governor and claimed the cost of additional clothing needed on the job as deductible under s 51(1). For example, the taxpayer was often required to change two or three times a day and also purchased hats, gloves and full evening dresses for formal occasions. The argument turns on the character of the expenditure in

¹⁸ Ibid at 4403.

¹⁹ I have never understood why food, drink and accommodation costs are allowable on business trips. However that issue is for another time.

²⁰ 94 ATC 4255.

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the hands of the particular taxpayer. Normally the Commissioner argues that expenditure on clothes which can be worn at any time by the taxpayer - not just at work - is expenditure of a private nature and hence not allowable as a deduction. The Federal Court in *Edwards* upheld the Administrative Appeals Tribunal decision that the additional expenditure was deductible and dismissed the Commissioner's appeal. As Gummow J reasoned, at first instance:²¹

There is nothing about the additional change of clothes in a work day for this taxpayer which serves a private purpose. Her personal requirements of modesty, decency and warmth are met by her first set of clothes for the day. Her additional changes of clothing throughout the day solely serve work-related purposes which enable the taxpayer to attend the wife of her employer in the performance of her duties at many different types of functions as Personal Secretary. The expenditure on the additional clothing is incurred in the course of gaining the income.

The point in reply could well be that, although the clothes satisfy the requirement that the expenditure on them was incurred in gaining or producing assessable income, the outgoings still retain their character as expenses of a private or domestic nature and as such should not be allowed as deductions. It is clear that expenditure can satisfy the first limb of s 51(1), yet still be denied a deduction because it is of a private nature.²² The essential character test will be applied to see if that is the case.²³ It is arguable that expenditure which has the essential character of a private or domestic nature should be disallowed in full, irrespective of whether it is also incurred in gaining or producing assessable income.²⁴ In other words there should be no apportionment, once the expenditure is characterised as being private or domestic. This line of reasoning, of course, contradicts *Edwards*.

In *Mansfield v FCT*²⁵ Hill J, in the Federal Court, allowed a flight attendant with Australian Airlines deductions for moisturiser, hair conditioner, shoes and hosiery. His Honour essentially allowed these claims because the harsh conditions of employment (in the aircraft), or the requirement to wear particular clothing as part of a

²¹ *FCT v Edwards* 93 ATC 5162 at 5165, quoted by the Federal Court in *FCT v Edwards* 94 ATC 4255 at 4257. Emphasis in the original.

²² *FCT v Cooper* 91 ATC 4396 at 4400 per Lockhart J.

²³ *Ibid*.

²⁴ *Ibid* per Lockhart J, citing *Handley v FCT* 81 ATC 4165 and *FCT v Forsyth* 81 ATC 4157.

²⁵ 96 ATC 4001.

uniform, meant the expenditure was incidental and relevant to her occupation as a flight attendant.²⁶ He denied a deduction for hairdressing, because it was of a private nature. There was nothing additional which showed any relationship between such hairdressing expenditure (for example, on perms) and the taxpayer's employment as a flight attendant.²⁷

His Honour's approach to the claim for a deduction for expenditure on moisturiser is instructive. Good grooming was an important requirement of the job as a flight attendant. It was recognised in the award, by the employer and in training manuals. In addition, the harsh working conditions of the flight attendant necessitated expenditure on moisturiser. His Honour said:²⁸

In my view, expenditure for moisturiser, the necessity for which was brought about by the harsh conditions of employment which Mrs Mansfield was called upon to endure, is incidental and relevant to her occupation as a flight attendant. It has the necessary connection with her activities in the cabin itself. It is these activities which are directly relevant to her gaining and producing assessable income by way of salary.

In other words, the conditions of employment, in this case described as harsh, and the necessity for flight attendants to be well groomed, both combined to make the expenditure incidental and relevant. It is not clear from Hill J's judgment whether the fact of a harsh working environment alone (for example working in the sun all day) would make expenditure on things like hats, suntan lotion, protective clothes and sunglasses deductible.

Mansfield could stand for the view that they will be allowable. Why? Because although there were two elements in *Mansfield* allowing deductibility, namely the harsh working conditions and the requirement to be well groomed, it does not appear from Hill J's judgment that both are necessary before a deduction is allowable. In the circumstances of *Mansfield*, either factor was sufficient to make the expenditure incidental and relevant to the earning of assessable income and hence allowable under s 51(1).

²⁶ Ibid at 4007- 4008, in relation to the moisturiser, 4008 for the shoes, 4008 for the hosiery and 4009 for the conditioner.

²⁷ Ibid at 4009.

²⁸ Ibid at 4007.

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The Commissioner has accepted the decision in *Mansfield*, but believes its application is limited.²⁹ Indeed in TR 96/D3 - a draft ruling on allowable deductions for personal care products issued after *Mansfield* - the Commissioner argues that the decision was based on the harsh working environment *and* the requirement to be well groomed. The Commissioner could well be in for a rude shock.

Cooper, *Edwards* and *Mansfield* are three recent examples of the courts' approach to the interpretation of s 51(1). It appears, at least from *Edwards* and *Mansfield*, that expenditure occasioned by the particular circumstances of the job may well be deductible, even though at first blush the expenditure appears to be personal and private. Unfortunately, a footballer playing for an acknowledged working class club was not able to convince the majority of the Federal Court of the same thing in relation to food and drink. The reason for the difference, if there is any logic to be found in these cases, is that it is not sufficient that the expenditure be occasioned by the particular circumstances of the income earning activity. It must also have a sufficient connection to the income earning activity. Its essential character must be as a business or working expense. In *Edwards* and *Mansfield* that was the case, in *Cooper* arguably it was not. A more prosaic explanation is that the decision in *Cooper* is incorrect.

The production/consequence dichotomy

The essence of s 51(1) is that to make money you have to spend money. This needs some qualification in the sense that there does not need to be a straight-line relationship between the expenditure and the production of assessable income. It is clear that for expenditure to be deductible it does not have to produce income.

For example, advertising expenses are allowable for a business, even if in the particular circumstances of the business they do not produce one extra sale. This is because they have the nature of a business expense, or, if you like, their essential character is an income earning expense.

Other expenses, too, have been held deductible, not because they directly produce income but because the business or income-earning activity is the occasion of the expenditure or causes the expenditure. Take defamation actions against newspapers. Depending on the success or otherwise of the action, there may be damages and legal

²⁹ ATO Media Release No Nat 96/01, 19 January 1996.

costs involved. These amounts are not directly productive of assessable income. Nevertheless defamation damages and legal costs incurred by a newspaper in defamation claims will be allowable to the newspaper as a deduction. Why? As Gavan Duffy CJ and Dixon J said in *Herald and Weekly Times v FCT*:³⁰

But this expenditure flows as a natural or necessary consequence from the inclusion of the alleged defamatory material in the newspaper and its publication.

Why was this? Because defamation claims are a regular and almost unavoidable consequence of publishing a newspaper. The defamation claims flow directly from the income earning activity, namely producing newspapers.³¹ In other words, the expenditures were an inevitable consequence of modern business³² and, as such, were deductible. The same argument would apply where expenditure is a necessary consequence of normal working activity not of a business nature.³³

Round up the usual suspects

In *Studdert v FCT*³⁴ Hill J identified two passages which, for his Honour, enshrined the true principle contained in s 51(1).³⁵ In *Ronpibon Tin* the High Court said:³⁶

In brief substance, to come within the initial part of the subsection it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income.

The principle has been expressed in various forms since then. For example, in *FCT v Smith* the High Court said:³⁷

What is incidental and relevant in the sense mentioned falls to be determined not by reference to the certainty or likelihood of the outgoing resulting in the generation of

³⁰ (1932) 48 CLR 113 at 118.

³¹ Ibid at 119.

³² Cooper, Deutsch and Krever, *Income Taxation: Commentary and Materials* (2nd ed 1993 Law Book Company) 9-10.

³³ See, for example, *FCT v Smith* 81 ATC 4114.

³⁴ 91 ATC 5006.

³⁵ Ibid at 5014.

³⁶ (1949) 78 CLR 47 at 57.

³⁷ 81 ATC 4114 at 4117.

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income but to its nature and character and generally to its connection with the operations which more directly gain or produce the assessable income.

All of this seems to lead inexorably to the conclusion that an outgoing will be deductible if it is incurred in gaining or producing assessable income! We have come full circle, back to the legislation, and it might be best to adopt the words of the Full Federal Court in *Edwards*, when it said: "Each case must be approached by the application of the section, properly construed, to its particular facts".³⁸

Perhaps another way of putting it might be to suggest that the essential character test is to be applied carefully in the circumstances of each case, examining in detail the nature of the income earning activity and the relationship the expenditure has with that activity.

Purpose

In addition to questions about the essential character of the expenditure, the courts have, in some instances, had to deal with the question of the taxpayer's purpose in undertaking the expenditure. This will be particularly relevant where the expenditure may well have been undertaken to produce the deduction rather than to produce assessable income and where it does not appear to be commercially appropriate.

In *Fletcher v FCT*³⁹ the High Court spelt out those circumstances in which the taxpayer's purpose would be a relevant consideration in determining how to characterise the expenditure. In essence these will be cases where the outgoing is voluntary and is larger than the income, if any, which results. Where the outgoing produces a larger amount of income than the outgoing itself, then there would not normally need to be an examination of the taxpayer's motive in undertaking the expenditure. On the other hand where the expenditure leads to no or less income than the amount of the expenditure itself, then the Court may well look at the objects the taxpayer had in mind in undertaking the expenditure.

Fletcher involved an annuity scheme purchased under a round robin of cheques so that the amount actually paid by the taxpayers was much less than the amounts referred to in the contracts. In addition,

³⁸ 94 ATC 4255 at 4258.

³⁹ 91 ATC 4950.

the scheme worked in such a way that there would be large losses for the first five years (because the income under the scheme would be much less than the interest claimed on the borrowings to purchase the annuity). In the next five years there would be small losses, and in the final five years there would be large taxable amounts received. The taxpayers could, however, pull out of the scheme before the last five years, thus avoiding receipt of the taxable income of those years. Not to put too fine a gloss on it, the arrangement appeared to be a fairly daring tax avoidance scheme. In relation to the deductibility of the interest the Court said, after quoting from *Ronpibon Tin* on the operation of s 51(1):⁴⁰

So to say is not, however, to exclude the motive of the taxpayer in making the outgoing as a possibly relevant factor in characterisation for the purposes of the first limb of s 51(1). At least in a case where the outgoing has been voluntarily incurred, the end which the taxpayer subjectively had in view in incurring it may, depending upon the circumstances of the particular case, constitute an element, and possibly the decisive element, in characterisation of either the whole or part of the outgoing for the purposes of the sub-section. In that regard and in the context of the sub-section's clear contemplation of apportionment, statements in the cases to the effect that it is sufficient for the purposes of s 51(1) that the production of assessable income is "the occasion" of the outgoing or that the outgoing is a "cost of a step taken in the process of gaining or producing income" are to be understood as referring to a genuine and not colourable relationship between the whole of the expenditure and the production of such income.

Nonetheless, it is commonly possible to characterise an outgoing as being wholly of the kind referred to in the first limb of s 51(1) without any need to refer to the taxpayer's subjective thought process. That is ordinarily so in a case where the outgoing gives rise to the receipt of a larger amount of assessable income. In such a case, the characterisation of the particular outgoing as wholly of a kind referred to in s 51(1) will ordinarily not be affected by considerations of the taxpayer's subjective motivation...

The position may, however, well be different in a case where no relevant assessable income can be identified or where the relevant assessable income is less than the amount of the outgoing. Even in a case where some assessable income is derived as a result of the outgoing, the disproportion between the detriment of the outgoing and the benefit of the income may give rise to a need to resolve the problem of the characterisation of the outgoing for the purposes of the subsection by a weighing of the various aspects of the whole set of circumstances,

⁴⁰ 91 ATC 4950 at 4957-4958. The actual quote can be found in the text accompanying n 36 above.

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including direct and indirect objects and advantages sought in making the outgoing. Where that is so, it is a "commonsense" or "practical" weighing of all the factors which must provide the ultimate answer. If, upon consideration of all those factors, it appears that, notwithstanding the disproportion between outgoing and income, the whole outgoing is properly to be characterised as genuinely and not colourably incurred in gaining or producing the assessable income, the entire outgoing will fall within the first limb of s 51(1) unless it is either somehow excluded by the exception of "outgoings of capital, or of a capital, private or domestic nature" or "incurred in relation to the gaining or production of exempt income". If, however, that consideration reveals that the disproportion between outgoing and relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that part only of the outgoing can be characterised by reference to the actual or expected production of assessable income, the apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary.

As the Court says, notwithstanding the disproportion between expenditure and income, it may still be possible to characterise the whole outgoing as incurred in gaining or producing assessable income. For example, advertising expenditure that produces no extra sales is in the normal course of events business expenditure and, unless there were suspicious circumstances (such as an exorbitant cost), the expenditure would be allowable.

The Court in *Fletcher* was referring only to voluntary outgoings. Where the expenditure arises as a consequence of the particular income earning activity the taxpayer "indulges" in, then it is not possible, in my view, to say that the outgoing can be characterised by reference to the actual or expected production of assessable income and so in that sense is not voluntary. The question of purpose and the distinction just drawn may be of relevance in regard to university fees when the fee is much larger than the AUSTUDY payments received by the student, and will be looked at further under that heading. Let us now look at some of the so-called self-education cases and see if they follow the general line enunciated in cases such as *Ronpibon Tin*, *Lunney*, *Cooper*, *Edwards* and *Mansfield*. To do that we first need to understand what self-education expenses are.

Self-education expenses

Self-education expenses are those expenses incurred by a student on their course of education. This includes fees (either university or conference), material charges, photocopying costs, travel and living

costs associated with the course, the cost of any equipment such as personal computers and so on. The amounts can be quite large. For example, the Legal Workshop fee at the Australian National University in 1996 was \$5,000 and the charge for materials provided during the course was \$125.

In relation to s 51(1) there appear to be a number of generalisations one can make about the deductibility of self-education expenses. Expenditure by a person in a job, on a course which will make them better able to do their present job, will be allowable.⁴¹ Or, as TR 92/8 puts it in paragraph 5:

If the subject of self education is directly relevant to the activities by which a taxpayer currently derives his or her assessable income, the expenses associated with the study are allowable as a deduction under subsections 51(1) and 54(1). This particularly applies if a taxpayer's income-earning activities are based on the exercise of a skill or some specific knowledge and the subject of self education enables the taxpayer to maintain or improve that skill or knowledge.

Education expenditure which will quite probably lead to promotion within the present job context will also be deductible. Paragraph 6 of TR 92/8 says:

If the study of a subject of self education objectively leads to, or is likely to lead to, an increase in a taxpayer's income from his or her income-earning activities in the future, then the self education expenses are allowable as a deduction.

Finally, expenditure which will lead to a new job (for example, by a full-time student hoping to find a job in the future as a consequence of the course), or a job in a new field, will not be allowable. The Commissioner, in paragraph 7 of TR 92/8, put it this way:

However, no deduction is allowable for self education expenses, if the study, viewed objectively, is designed to enable a taxpayer to get employment, to obtain new employment or to open up a new income-earning activity (whether in business or in the taxpayer's present employment). This includes studies relating to a particular profession, occupation or field of employment in which the taxpayer is not yet engaged. The expenses are incurred at a point too soon to be regarded as incurred in gaining or producing assessable income.

⁴¹ In all of this discussion I am assuming none of the negative limbs, such as the expenditure being capital or private expenditure, applies.

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These propositions come out of principles developed by the courts and tribunals over the last 40 years.

Self-education cases

In *FCT v Finn*,⁴² a senior architect with the Western Australian Department of Works undertook overseas travel, while on combined long service leave and recreation leave to bring himself up to date with architectural developments in Europe and South America. It was at the request of the Department that he altered his plans and went to South America, as well as Europe. The taxpayer was a senior architect, on the top of his salary range. He undertook the trip to better equip himself for promotion. It was clear from the evidence that the taxpayer spent the whole time away on architecture and its study. Finn claimed a deduction for unreimbursed expenses covering items such as airfares, meals and accommodation.

According to Dixon CJ, there were four reasons why the expenses were deductible. First, the increased knowledge the taxpayer gained (ie, of modern developments in design and construction) "made his advancement in the service more certain, and ... in respect of promotion to a higher grade these things [ie, his increased knowledge] might prove decisive".⁴³ Secondly, "advancement in grade and salary formed a real and substantial element in the combination of motives which led to his going abroad".⁴⁴ Thirdly, the Government and Department heads treated his increased knowledge "not only of distinct advantage to his work for the State but of real importance in at least one project in hand".⁴⁵ Finally, his overseas trip was being undertaken "while he was in the employment of the government, earning his salary and acting in accordance with the conditions of his service".⁴⁶

On this basis, his Honour concluded that the taxpayer's journey abroad was "incidental to his employment and most relevant to it"⁴⁷ and therefore allowed the claim.

Both Kitto and Windeyer JJ emphasised that a professional position such as that occupied by the taxpayer required more than just the

⁴² (1961) 106 CLR 60.

⁴³ Ibid at 67.

⁴⁴ Ibid.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid at 68.

performance of set duties. It also involved keeping up to date with latest developments. For example, Windeyer J said:⁴⁸

Generally speaking, it seems to me, a taxpayer who gains income by the exercise of his skill in some profession or calling and who incurs these expenses in carrying on his profession or calling and who incurs expenses in maintaining or increasing his learning, knowledge, experience and ability in that profession or calling necessarily incurs those expenses in carrying on his profession or calling.

Two important elements come out of *Finn*. First, expenditure by a person to maintain and improve the skills relevant to the position they are presently in will be deductible. This seems to be a sensible approach. It recognises that jobs, and the skills associated with them, are not static and that it is an integral part of most employment for a person to maintain, update and improve their knowledge to successfully carry out their duties. Secondly, where that expenditure is likely to lead to promotion in the same field, it will also be deductible.

This last proposition is questionable. Even if a promotion is similar to the previous job, there are many promotions which appear to be so qualitatively different as to be essentially a new job. Why, then, is the expenditure in those cases not incurred too early in the process of gaining or producing this future assessable income? The answer appears to be that the courts have taken a wide view of what constitutes the income-earning activity in relation to a job, so that promotions within the same firm or department are considered the same type of job.

Dixon CJ in *Finn* rejected the argument put forward by the Commissioner that the expenditure on gaining improved and up-to-date knowledge was of a capital nature and therefore not allowable under s 51(1). His Honour said:⁴⁹

You cannot treat an improvement of knowledge in a professional man as the equivalent of the extension of plant in a factory. Unfortunately, skill and knowledge of most arts and sciences are not permanent possessions: they fade and become useless unless the art or the science is constantly pursued or, to change the metaphor, nourished and revived. They do not endure like bricks and mortar.

⁴⁸ Ibid at 70.

⁴⁹ (1961) 106 CLR 60 at 69.

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A comparison of *Lunney* and *Finn* is most informative. The High Court in *Lunney* says that, even if you satisfy a "but for" test ("but for" the expenditure on fares the taxpayer would not have been able to earn assessable income), you will not necessarily be entitled to a deduction. Whether you are or not depends on whether the expenditure has an income-earning character as its essence. Yet, in *Finn* the expenditure was deductible, even though the taxpayer could not satisfy a "but for" test. Irrespective of whether the expenditure on the trip was undertaken, the taxpayer would still have earned his assessable income as a senior architect. However, to talk in "but for" terms is to miss the point. The real point is that maintaining and upgrading knowledge is an integral part of skilled jobs, (if not most jobs these days), whereas getting to and from work is only a prerequisite to earning income. The expenditure in *Finn* was of the very essence of the job; in *Lunney* it was only a precursor.

The question of the likelihood of promotion was examined in more detail, among other things, by Menzies J in *FCT v Hatchett*.⁵⁰ In that case a primary school teacher claimed two lots of self-education expenditure as deductions. The first claim, for \$89, related to the submission of a thesis to gain a Teacher's Higher Certificate. The grant of the certificate entitled a teacher to transfer to a higher payment scale and advance further on that scale. The submission of the thesis was the last step in the grant of the certificate. It led to an increase in salary (by being paid under the higher scale) for doing exactly the same job.

The second claim was for \$71 for university fees for Arts Faculty subjects. A university degree was a requirement for promotion to the position of headmaster or deputy headmaster in a secondary school.

The claims were made in relation to the year ended 30 June 1967 (having been expended in that income year), although the certificate was not granted until the next income year. This timing factor did not mean the deductions had to be denied. As Menzies J said:⁵¹

It is now beyond doubt that, in considering this question, consideration must be given to assessable income of future years as well as that of the year in which the outgoing occurs.

⁵⁰ (1971) 125 CLR 494.

⁵¹ *Ibid* at 498.

In relation to the certificate, his Honour held the expenditure involved in submitting the thesis was deductible. There was a clear connection between the expenditure in one income year and earning assessable income in the next and future income years. When it was granted, it entitled him forthwith to more pay for the same work and, as such, expenditure relating to the certificate was deductible.

This was not so for the expenditure on the university fees. Even though the employer had encouraged the taxpayer to undertake the course, this was not enough to make the outgoing deductible. His Honour said:⁵²

As I have said, I am not able to find any connection between the payment of the fees and the assessable income of the taxpayer beyond the circumstance, which I take to be self-evident, that a teacher who has pursued university studies is likely to be a better teacher than if he had not done so and is therefore more likely to obtain promotion within the department. In my opinion this general consideration is not enough to make the fees deductible; there must be a perceived connection between the outgoing and assessable income. Had the taxpayer paid fees for subjects in the faculty of law it would, I think, have been obvious that the fees were not allowable deductions. In my view the payment of such fees would have had as much connection with the taxpayer's assessable income as the fees in fact paid.

This perceived connection analysis has received some criticism. First, is it a subjective or objective perception which is required, ie, who does the perceiving - the taxpayer, the Commissioner, or some mythical objective third party? In addition, the idea of a perceived connection is arguably somewhat removed from the words of s 51(1). In TR 92/8 at paragraph 17 the Commissioner said:

The many later cases [ie, after *Ronpibon Tin* in 1949] dealing with self education expenses and subsection 51(1) are no more than examples of the application of these general principles [eg, incidental and relevant] to the facts of those cases. Application of the principles provides an indication of the facts relevant in the self education area in determining the characterisation issue. However, we consider that expressions used in some of the cases, such as "a perceived connection between expenditure and the gaining of assessable income", "direct effect on income", "part and parcel of the employment" or "express or implied condition of employment" are not substitutes for the conditions for deductibility for self education expenses under subsection 51(1).

⁵² Ibid at 499.

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The important point is that the question has to be, how can one characterise the expenditure? You have to look at the expenditure in the context of the income activities. All the perceived relation test does is put the essential character test in another form. It says that if there is not a sufficient relationship between the expenditure and the income then the essential character of the expenditure is not income related and the expenditure as a consequence is not deductible.

In addition, Menzies J's comment may appear to contradict the analysis already undertaken of *Finn*, in the sense that *Hatchett* denies expenditure on university fees to make one a better teacher and so better able to carry out present duties. In *Finn*, it was clear that one factor in the decision was precisely that the type of study undertaken would in fact make the taxpayer a person better able to exercise the skill and talent required in his then job. One way of explaining the difference is that, in *Finn* the study was within the specific area of skill the taxpayer exercised, whereas in *Hatchett* the connection between teaching and Arts units was more remote. Another possible explanation is that Menzies J on this point is wrong. In any event, the narrow nature of *Hatchett* in this situation has been disregarded in later cases.

Another factor in the decision, and one which assumes some importance in other decisions, was that the taxpayer in *Hatchett* had not shown much academic brilliance in his Arts degree. Initially the taxpayer had enrolled in a Bachelor of Education course and passed only three units. When that course tightened its requirements, the taxpayer received credit for those three units towards an Arts degree. The taxpayer began the University course in 1960 and by the end of the decade had passed only six subjects. As Menzies J said:⁵³

Having regard to the taxpayer's lack of success in passing university examinations it is not possible to find affirmatively that there exists any connection between the payment of the university fees in 1967 and the earning of assessable income at any time in the future. The prospects of the taxpayer obtaining a university degree leading to his promotion to positions in the service for which a university degree is a prerequisite affords no grounds for concluding that the Commissioner was in error in refusing to allow the fees paid as deductions.

⁵³ Ibid at 497.

Later self-education cases have some relevance to this discussion. Both *FCT v Smith*⁵⁴ and *FCT v Lacelles-Smith*⁵⁵ involved Tax Office employees. They both claimed various expenses (such as books, tuition fees, travel expenses and photocopying) as allowable deductions under s 51(1). In *Smith*, the taxpayer was a clerk who had applied to attend the Tax Office assessing school. His application was rejected because he was not enrolled in an approved tertiary course. The assessing school provided training for departmental officers to become assessors grade 1. There were six grades of assessors and, from a certain grade, it was a requirement that the applicant have certain qualifications.

Smith enrolled in an approved course, was accepted into the assessing school, passed the tests involved in the school and was appointed an assessor grade 1 as a consequence. This was not technically a promotion, since Smith had been acting in a position at the same level (although not as an assessor). However, his appointment as an assessor meant he was now permanently appointed at that level. In addition, appointment to an assessor grade 1 opened up a career structure of promotions, upon satisfactory completion of his duties and subject to certain degree requirements at the higher levels. In fact, the taxpayer was promoted fairly quickly and became an assessor grade 4 a few years after becoming a grade 1.

The taxpayer had passed most units he had undertaken in his Bachelor of Commerce degree, although he had failed two, and at the time of the hearing had not finished the course.

Waddell J refined Menzies J's decision in *Hatchett*. Of that decision his Honour said:⁵⁶

In my opinion this decision does not establish that educational expenses of the kind here in question must, in order to be deductible, relate to a course of study which has as its necessary consequence an increase in salary. What *Hatchett's* case decides, I think, is that educational expenses which have the necessary consequence of an increase in salary are deductible and that educational expenses paid in respect of a course which, if successfully completed, makes the taxpayer likely to do a better job and therefore more likely to obtain promotion, but which the taxpayer had no real prospect of completing, are not deductible.

⁵⁴ 78 ATC 4157.

⁵⁵ 78 ATC 4162.

⁵⁶ 78 ATC 4157 at 4161.

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Enrolling in the course enabled the taxpayer to do the assessing school and become an assessor. Continuing the course was a practical necessity to qualify for promotion to grades 3 and 4. Completion of the course was essential for appointment to grades 5 and 6.

It seems clear that there is a sufficient nexus between the expenditure and earning assessable income to make the expenditure deductible. As Waddell J said:⁵⁷

In my opinion these circumstances establish a real connection between the expenditure and the taxpayer's assessable income in the sense that the commencement of the course was reasonably calculated to lead to an increase in his income in future years for the reasons already given, that it had in fact led to the confirmation of his salary range by his appointment as Assessor Grade 2, and his continuation with the course had, during the year of income, led to an increase in his salary, namely upon his appointment as Acting Assessor Grade 3 ... and was reasonably calculated to lead to future increases, as in fact occurred. In short, in incurring the expenditures in question the taxpayer, in reliance upon the prospects of promotion which appeared reasonably to be present, spent money to earn more money in the future.

A similar situation arose in *Lacelles-Smith*,⁵⁸ although the taxpayer was eventually excluded from the University course because of a number of failures. He was allowed the expenses claimed because commencing the course enabled him to undertake the assessing school and be appointed an assessor grade 1, a promotion in *Lacelles-Smith's* case. Continuing in the course (before he was excluded) was "likely in all probability"⁵⁹ to have led to promotion as an assessor, and this in fact occurred. There was a clear connection between the expenditure and the earning of assessable income.

So, it seems clear on the basis of these decisions that expenditure associated with a course of study which is reasonably calculated to lead to an increase in salary will be deductible.

The Commissioner had argued in *Smith* that the taxpayer was obtaining fresh qualifications.⁶⁰ If by this the Commissioner meant he was undertaking a course which would give him access to a new field, then there is some merit in the argument. *Smith* was a clerk in

⁵⁷ Ibid at 4162.

⁵⁸ 78 ATC 4162.

⁵⁹ Ibid at 4163.

⁶⁰ 78 ATC 4157 at 4158.

the Tax Office who wanted to move into a new field - assessing. Why was this not important? It appears that Waddell J took a wide view of the job Smith was in - he was a Tax Officer and one aspect of tax was, in the days before self-assessment, assessing. So, rather than opening up a new field of employment, the course enabled him to extend his present field.⁶¹

In *FCT v Studdert*⁶² the taxpayer was a Qantas flight engineer who claimed a deduction of \$7,240 for flying lessons he took in the 1986/87 income year. Flight engineers supervise and regulate the delivery of power to the aeroplane from the engines. They sit directly behind the first officer, who sits next to the captain. The Administrative Appeals Tribunal found that the flying lessons enabled the taxpayer to better carry out his duties as a flight engineer. The Tribunal also accepted that proficiency in flying would assist the taxpayer in being promoted to higher grades of flight engineer.

The Commissioner argued that the taxpayer's main motivation in undertaking the lessons was to be retrained for the duties of a flight officer. The Tribunal accepted Studdert's evidence that his motive was to make him more efficient in his duties and enhance his prospects of promotion.

Hill J undertook a fairly lengthy discussion of the relevance of motive to deductibility. He examined *Magna Alloys & Research Pty Ltd v FCT*,⁶³ a Full Federal Court decision which allowed a deduction to a company for defence costs of directors charged with criminal offences related to the business. The deduction was allowed, despite the fact that the dominant purpose of the taxpayer company was to protect the interests of the directors. There was also another motive present, namely to protect and preserve the taxpayer's business. The reason for deductibility was, according to Deane and Fisher JJ, that expenditure could still be necessarily incurred in gaining or producing assessable income (the second limb business test of s 51(1)) even if the dominant motive was a non-business one.

The taxpayer in *Studdert* had an appropriate purpose, namely to become a better flight engineer. There was sufficient connection between the outgoing and earning assessable income to allow it as a

⁶¹ This is my view, not Waddell J's.

⁶² 91 ATC 5006.

⁶³ 80 ATC 4542.

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deduction. According to Hill J, the decision would not necessarily have been different, even if the sole purpose of the taxpayer had been to retrain as a flight officer.⁶⁴ His Honour confined *Fletcher* to its facts, highlighting the fact that it involved what seemed a fairly audacious tax avoidance scheme.

For all of these reasons his Honour concluded as follows:⁶⁵

While the motivation of the taxpayer in a case such as the present is not an irrelevant matter in the question of characterisation, once it was found that Mr Studdert did have, as one of his purposes or motives in incurring the outgoing, the improvement of his performance as a flight engineer, it was unnecessary for the tribunal to determine whether, if he also had the motive of undertaking retraining as a flight officer, the latter motive was dominant or not.

This seems to directly contradict the approach of the High Court in *Fletcher*. The Commissioner, in paragraph 9 of TR 92/8, strongly disagrees with Hill J's approach. There is much merit in his argument. The Ruling in this regard reads:

When determining whether any self education expenses can be characterised as having been incurred in gaining or producing assessable income, it is, at the least, a relevant matter to consider whether a non-income producing purpose was the dominant purpose for the incurring of the expenses. To the extent that comments of the Federal Court of Australia (Hill J) in *FCT v Studdert* ... might be interpreted as suggesting otherwise, we believe that this view is inconsistent with the decision of the High Court of Australia in *Fletcher v FCT* ...

The problem with Hill J's approach is that any taxpayer in the self-education field will claim that one of their motives was to become a better employee in their present job (assuming that the course provides some basis for saying this). Hill J's analysis is really a backdoor way of denying that motive or purpose are that important. In any event, if the taxpayer has dual motives, one relating to non-income earning and the other to income earning, why not apportion the deduction? That approach is consistent with *Fletcher*.

Indeed, in *Ure v FCT*⁶⁶ the Federal Court apportioned a claim for interest. The taxpayer had borrowed money at commercial rates (up to around 12.5%) and on-lent it at 1% to his spouse. He declared the

⁶⁴ 91 ATC 5006 at 5011.

⁶⁵ Ibid at 5012.

⁶⁶ 81 ATC 4100.

interest of 1% as assessable income and claimed the interest paid on the loan as a deduction under s 51(1). The Court only allowed a deduction up to the amount of interest income actually received (ie, 1%) on the basis that the taxpayer had income and non-income earning motives (and the income motives were subordinate) and therefore the claim should be apportioned.

Hill J, in *Studdert*, went on to decide that the fact that the flying lessons improved the taxpayer's ability as a flight engineer (ie, in his present job) was enough to make the expenditure deductible. As his Honour pointed out, it is not necessary for expenditure to be productive of extra income. If this were the case, people who had reached the top of their profession (eg, the Commissioner of Taxation), would be denied a deduction for undertaking a course which made them better at their job.

On the basis of increased efficiency in the present job (and the taxpayer's motivation to better perform his present job), Hill J held that the claim for the cost of the lessons was allowable. If this factor were coupled with the fact that proficiency in flying would assist the taxpayer in promotion, then it made "the conclusion inexorable that the outgoing in question was incurred by Mr Studdert in gaining or producing his assessable income".⁶⁷

On the question of a taxpayer taking up a new job, or moving to a new field, the courts and the Commissioner have consistently asserted that the self-education expenditure occurs too early to be related to the production of income in that new job or field. For example, as Menzies J said in *FCT v Maddalena*,⁶⁸ in relation to the expenses of an employee in changing from one job to another: "The expenditure would have been obtained in getting, not in doing, work as an employee. It would come at a point too soon to be properly regarded as incurred in gaining assessable income".

Of course, if one wanted to be mischievous one could say that a promotion within the same organisation is, in many cases, a new job and that the expenditure is thus, arguably, too soon to be regarded as incurred in gaining assessable income. Such an argument, based on the cases already dealt with, would find little favour.

⁶⁷ 91 ATC 5006 at 5016.

⁶⁸ 71 ATC 4161 at 4163.

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The problem arises (as *Studdert* shows to some extent) in the application of the principle outlined by Menzies J in *Maddalena* to actual fact situations. When is a job a new job?

In *FCT v Highfield*⁶⁹ the taxpayer was a dentist in general practice, who carried on some periodontic work. He wanted to specialise in periodontics and eventually went and studied periodontics in the United Kingdom for a year. He came back to Australia, sold his practice to the dentist who had leased it and spent another year gaining clinical experience in periodontics. He was then registered as a specialist in periodontics.

The taxpayer claimed the cost of his trip to London to study as self-education expenses allowable under s 51(1). Lee J, of the Supreme Court of New South Wales, held that the taxpayer, when he set off to London, had it in mind that the study would enable him to undertake more periodontic work in his general practice, with a view eventually to practise as a periodontist, rather than specialise solely in periodontics immediately on his return.

His Honour also held that the taxpayer was only temporarily away from his practice and, as such, continued to carry on business while he was overseas. His Honour held that the claim relating to the costs of the overseas trip was allowable. He said:⁷⁰

The objective facts in regard to his practice, the fact that it had a significant periodontic component and that the respondent had a special interest in that component and a desire to attract more complicated work to it establishes the high probability that additional skill in periodontics would enable higher fees to be charged for that work and that there would be less need to refer some not simple periodontic work to specialists.

The connection between higher fees for more specialised periodontic work in the general practice was sufficient to establish the necessary connection between the outgoing and assessable income.

Highfield is a case which rests on particular findings of fact, namely that the taxpayer already undertook periodontic work in his general practice, that he intended to return to general practice on return from overseas and that he continued in business while he was overseas. If the taxpayer's intention had all along been to work as a specialist periodontist then, on the basis of other authorities, such as

⁶⁹ 82 ATC 4463.

⁷⁰ Ibid at 4471.

Maddalena, he would not have been able to claim a deduction. Lee J was not so sure in his obiter discussion of the issue,⁷¹ but there appears little doubt that denying deductibility in that situation would have been the correct result.

Other decisions have similarly been lenient in their analysis of what constitutes a new job. For example, *Case T 78*⁷² involved a law clerk in a law firm who had been admitted to practise as a barrister, but who had not yet undertaken the requisite study or work to become a solicitor. He claimed the cost of travel to the UK to do a graduate course in international law as deductible on the basis that it was his intention to practise as a barrister and specialise in the field of international law. In other words, his claim was essentially for a deduction against future income as a barrister. Indeed, when he returned from the overseas course he went to the Bar and began to practise as a barrister. The Administrative Appeals Tribunal upheld the claim, mainly, it seems, on the basis that he was already admitted as a barrister before he left and his activities as a law clerk were to give him experience in that field to enable him to be a better barrister. The same is true of the course, which would make him a better barrister.

The problem with this decision is that the taxpayer had earned no income as a barrister prior to going overseas. Indeed, the course appears precisely to be one that equipped the person with skills to enable him to specialise as a barrister in a particular field. The decision could just as easily have gone the other way, holding that the expenses were incurred on gaining qualifications for a new job and were thus not deductible.

Another Administrative Appeals Tribunal decision which may be of relevance to Legal Workshop students is *Case Z1*,⁷³ involving a public servant who was a legal officer. She undertook the New South Wales, equivalent of the Legal Workshop and was denied a deduction, inter alia, for the costs associated with the course. The taxpayer was a public servant who undertook external law studies with Macquarie University while she was working for the New South Wales Public Service in Magistrates Courts Administration. To become a Clerk of Petty Sessions or a Chamber Magistrate it was necessary to be admitted as a solicitor.

⁷¹ Ibid at 4473-4474.

⁷² 86 ATC 1094.

⁷³ 92 ATC 101.

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Later, while still studying law, she won a position with the Department of Consumer Affairs. She dealt with consumers and merchants, both at the counter and over the phone. She gave advice on a wide range of legislation. She took leave, paid and unpaid, from the Department of Consumer Affairs, to do the six month College of Law course. Successful completion of the course would enable her to be admitted as a solicitor. She intended to apply for a position as a legal officer in the Department.

However, after she finished her course, it became clear that, because of budgetary constraints, there would be no legal officer position available for some time. After being admitted as a solicitor she won a position with the NSW Director of Public Prosecutions. It was a condition of the job that the applicant be admitted to practise as a solicitor. The Administrative Appeals Tribunal, in denying deductibility, said:⁷⁴

To satisfy the nexus between the college expenses and the gaining of assessable income, in other words to show that the expenses were in relation to an activity incidental and appropriate to the office, the applicant must show that there is an explicit or implicit condition of the office that the expenses be incurred. At all relevant times, the applicant was in the employ of the Department of Consumer Affairs where qualifications as a solicitor were not necessary, although the gaining of such qualifications was encouraged. It seems to me that the course pursued by the applicant during the relevant financial year was of her own choice and for her own self-improvement. It could not be said to be "part and parcel" of her employment. It is not sufficient to say that the payment of the college expenses enhanced her ability to perform the duties of her employment. The authorities indicate that the nexus must be much more than that.

With all due respect, this decision is wrong. The authorities the Tribunal member relied on represented a fairly restricted approach to self-education expenses and the approach cannot stand in the light of Hill J's judgment in *Studdert*. Clearly, self-education expenditure to improve the performance of a taxpayer in their present job is allowable and *Case Z1* should be rejected. It appears that *Case Z1* was decided two days before the decision in *Studdert*. The member could have benefited from that decision. There is no "part and parcel" requirement for the deductibility of self-education expenses. The Commissioner said much the same thing in paragraph 10 of TR 92/8 and Hill J in *Studdert* casts doubt on the correctness of the very decisions relied upon by the Administrative Appeals

⁷⁴ Ibid at 106.

Tribunal in *Case Z1*.⁷⁵ In particular, his Honour suggests that the "part and parcel" test is not appropriate in determining deductibility of self-education expenses and adds:⁷⁶

I would prefer to rely upon the words of s 51(1) itself, and pose the question, which involves a conclusion of fact, whether the outgoing was incurred in gaining or producing assessable income.

AUSTUDY

The discussion so far about self-education expenses has to be modified if the student is earning AUSTUDY. AUSTUDY is a scholarship paid to students under the Students and Youth Assistance Act 1973 to provide assistance to students over 16 undertaking full-time study. It is payable, in general, to Australian citizens undertaking full-time study who meet (or whose parents meet) certain income and asset criteria.

AUSTUDY payments are included in assessable income. Paragraph 23(z) of the Income Tax Assessment Act 1936 exempts from income tax income that is derived by way of a scholarship, bursary or other educational allowance or assistance by a student receiving full-time education at a school, college or university. However the exemption does not apply to AUSTUDY payments. (Note, however, that any component of the AUSTUDY allowance which relates to a dependent child is exempt.) Indeed, the definition of salary and wages in s 221A of the Income Tax Assessment Act 1936 specifically includes AUSTUDY payments.

AUSTUDY (or rather its predecessor) was included in assessable income from 1 January 1986, as part of an increased spending package on youth. Part of that package involved increasing AUSTUDY payments to roughly the equivalent of the dole, so that there was no disincentive to studying. Of course, the dole was assessable, so the decision was taken to include AUSTUDY in assessable income as well. The fact that this new tax significantly reduced the cost of the youth package obviously did not figure in the Government's calculations at all.⁷⁷

⁷⁵ 91 ATC 5006 at 5015.

⁷⁶ Ibid.

⁷⁷ Not much!

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Under TR92/8 the Commissioner seems to accept that self-education expenses can be deducted against AUSTUDY. Thus, in paragraph 16 the ruling says, after discussing the deductibility of self-education expenses against assessable income, that "assessable income includes AUSTUDY allowances paid under the Student Assistance Act 1973 (SAA)". It appears that the Commissioner regards AUSTUDY as somehow flowing from the study students undertake. For example, he says in paragraph 45 of TR 92/8 that, the ATO "recognises that there are some situations where income-earning activities are carried out at an institution, eg trainee teachers attending teachers' college during their traineeship and students receiving AUSTUDY allowances under the SAA".

If students in receipt of AUSTUDY are gaining assessable income, then any expenses sufficiently associated with that income (ie, in the course of gaining or producing it) are allowable as deductions. For example, if a full-time student whose only income is AUSTUDY spends money on fees, books and so on, then arguably that expenditure is incidental and relevant to the production of assessable income and so allowable under s 51(1). Although the Commissioner does not expressly say so in TR 92/8, that seems to be the logical conclusion to what he has written.

A fuller explanation of the Commissioner's view of the deductibility of self-education expenses against allowances like AUSTUDY appears in IT 2412. Although that ruling (along with a number of other self-education rulings) was withdrawn by the "omnibus" ruling TR 92/8, there is nothing contained in TR 92/8 which contradicts that earlier ruling. It appears that in TR 92/8 the Commissioner's approach to the deductibility of things like fees against AUSTUDY remains the same as that found in IT 2412.⁷⁸

IT 2412 bases its approach to the deductibility of expenditure, such as student union fees, tuition fees, textbooks and the like, against AUSTUDY, on an old Canberra Income Tax Circular memorandum, CITCM No 525, issued in 1946. That CITCM says, at paragraph 5, that expenses which the holder (of a scholarship) is required to meet in fulfilling the terms under which a scholarship is granted are regarded as incurred in gaining or producing the assessable income received under the scholarship. Paragraph 7 of the CITCM tells us that lecture and tuition fees, textbooks and equipment are the types

⁷⁸ The Commissioner is re-examining his position on the deductibility of self-education expenses against AUSTUDY.

of expenditure which will be allowable as deductions to scholarship holders.

Paragraph 11 of IT 2412 adopts this logic and says that recipients of AUSTUDY are entitled to deductions under s 51(1) for the following expenses - student union fees, tuition fees, textbooks, instruments, equipment, material, field excursions, stationery, printing and other incidentals. From the treatment of self-education expenses in TR 92/8 and the treatment of AUSTUDY as income earning activity, it seems fairly clear that the Commissioner considers that expenses of the type described above will continue to be deductible against AUSTUDY.

Of course, it may be argued that a scholarship (which is what CITCM 525 covered), is very different to AUSTUDY and that, therefore, the logic of CITCM 525 should not be carried over to TR 92/8. In fact, the two are similar. Both are a form of educational allowance enabling a student to study.

Self-education expenses do not directly produce AUSTUDY; rather they arise in the course of gaining or producing AUSTUDY. They arise as a consequence of being a student and it is this characteristic of the particular individual, ie, being a full-time student within certain means tested limits, which enables the taxpayer to receive AUSTUDY. A student derives AUSTUDY through income-earning activity, meaning study, ie, attending lectures, reading, writing etc. A necessary consequence of this activity is spending money on fees, books, photocopying and so on. They are an unavoidable incident for AUSTUDY students of their income earning activity, namely being a student.

As a consequence of being a student they therefore have to spend money on items such as fees, books and so on. So, this type of expenditure is incidental and relevant to earning their AUSTUDY income as a student. The self-education outgoings have thus been incurred in the course of gaining or producing the assessable income, in this case AUSTUDY.

Legal Workshop

Legal Workshop is a six month course run in first and second semester at the ANU. Successful completion of the course results in the award of a graduate diploma and enables participants to practise as a barrister and solicitor in most jurisdictions in Australia.

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After a bitter struggle during 1994, the University was successful in imposing fees on students undertaking the course in 1995 and beyond. The compromise fee for that year and 1996 was set at \$5,000, although it is anticipated that the figure will rise in the next few years to around \$9,000.

AUSTUDY is paid fortnightly. For the purposes of exposition we will deal with a 22 year old student without a partner or dependents, who is enrolled in the Legal Workshop course in 1996. Assuming the student has no other income, they could be paid \$256.70 a fortnight, or \$6,691 per annum. Thus a full-time student enrolled in the Legal Workshop in first semester 1996 may well have received \$6,691 for the income year 1995/96, assuming they were in full-time undergraduate law study in second semester 1995.

For those situations where the AUSTUDY is greater than fees and other self-education expenses (if the arguments developed above about the deductibility of such expenses against AUSTUDY are accepted), then no problem seems to arise and the full amount of the expenditure (less the first \$250 under s 82A of the Act) will be allowable.

There may, however, be problems where the self-education expenses are greater than AUSTUDY. For example, a student enrolled in second semester in the ANU Legal Workshop beginning in July 1996 will only receive AUSTUDY payments for those six months, assuming she finished undergraduate law study at the end of 1995 and waited out the next six months before she did the Workshop. In other words, her AUSTUDY income for the 1996/97 income year will, at the maximum independent rate, be \$3,345 (half \$6,691). The student will have an excess of deductions over AUSTUDY of \$1,780, once the \$5,000 workshop fee and \$125 materials charge is deducted from her AUSTUDY assessable income (leaving aside any other self-education expenses she may be able to claim).⁷⁹

Once it is accepted that self-education expenses can be claimed against AUSTUDY, as the Commissioner apparently does then, at first blush, there appears to be no reason in principle to deny the student a full deduction for materials charge and fees, ie, for \$5,125.

⁷⁹ I have assumed, for the purposes of this example, that the student has another \$250 of self-education expenses and that this amount is denied deductibility under s 82A of the Income Tax Assessment Act 1936.

The practical problem (at least from the Commissioner's point of view) is that, having accepted that self-education expenses can be offset against AUSTUDY, the student in the example detailed above will, in effect, be able to deduct some self-education expenses against future non-related income. Suppose, for example, the full-time student found employment in January 1997 as a solicitor in a firm in Canberra and was paid, say, \$30,000 per annum. In her case this would result in half that amount being included in assessable income for the year ended 30 June 1997. A simplistic analysis would suggest that the student would, in effect, be able to claim the self-education loss of \$1,780 as a deduction against her solicitor's income under s 51(1). The net effect would be to reduce her solicitor's assessable income of \$15,000 to \$13,170 of taxable income. The end result appears to be that the student has been able to flow through a loss resulting from a self-education expense to future income.

In a slightly different situation, no such deduction would be allowable. Assume, for example, that the full-time student had no job, earned no AUSTUDY or other income while she was at the Workshop, and after successfully completing the course in December 1996 won a position as a solicitor in January 1997. She would not be allowed a deduction for the Legal Workshop fee against her income as a solicitor, because the expenditure was not incurred in gaining or producing assessable income - in the words of paragraph 7 of TR 92/8 "the expenses are incurred at a point too soon to be regarded as incurred in gaining or producing assessable income".

The Commissioner's argument could be that students receiving AUSTUDY may well have found a backdoor way around this position, if the fees are greater than the AUSTUDY income and the excess is offset against other non-related income of that or future years. As we shall see, that argument is flawed and in fact the students are not getting excess deductions on the sly.

The logical consequence of the Commissioner's likely argument seems to be that the Tax Office could somehow try to limit large self-education expenses to the level of the AUSTUDY income received.

Apportionment

The phrase "to the extent" in s 51(1) allows apportionment of expenses.⁸⁰ From the Commissioner's point of view, the answer to the problems created where self-education expenses exceed

⁸⁰ *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 55.

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AUSTUDY seems to be to apportion the deduction and allow the self-education expenses up to the level of AUSTUDY actually included in assessable income for the year. Thus, the student, having earned \$3,345 AUSTUDY, would only be allowed a deduction under s 51(1) of that amount, even though the expenditure on the fee and materials charge is \$5,125. This means that if she earns other income, say as a solicitor, there would be no tax loss and hence no backdoor deduction of self-education expenses against that other income.

Besides being a pragmatic approach, is this apportionment justifiable under the terms of s 51(1) and the judicial pronouncements on it? No. In *Ronpibon Tin* the High Court distinguished at least two types of apportionable expenditure. They said:⁸¹

It is perhaps desirable to remark that there are at least two kinds of 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 some other cause. In such cases it may be possible to divide the 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. Of this directors' fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income.

The important point that comes out of this passage is that the High Court says apportionment is appropriate where there were dual purposes or "causes". This was extended in *Fletcher* to an examination of purpose in those cases where the expenditure is greater than the income gained, so that if there is a duality of purpose (both income producing and other), then it will be necessary to apportion the "outgoing between the pursuit of assessable income and the pursuit of that other objective".⁸²

For a student on AUSTUDY paying the Legal Workshop fee, there does not appear to be the duality of purpose or cause that would enable apportionment. The expenditure is not, to use the High Court's phrase from *Fletcher*, "colourably incurred in gaining or producing assessable income".⁸³ The whole amount is incurred in the

⁸¹ (1949) 78 CLR 47 at 59.

⁸² 91 ATC 4950 at 4958.

⁸³ Ibid.

course of gaining or producing assessable income and so the whole amount should logically be deductible.

If the income earned is less than the expenditure associated with that income, and the expenditure is a voluntary one, then the High Court in *Fletcher*⁸⁴ says that the purpose of the taxpayer in making the expenditure can be looked at to determine if apportionment is appropriate. *Fletcher*, of course, dealt with a tax scheme where the taxpayers wanted huge tax losses in the first few years.

That is a very different case to the one in which the student finds herself. For a start, the expenditure is not really voluntary in the sense described in *Fletcher*. It arises as a consequence of the particular activity the student is undertaking, namely studying for the Legal Workshop diploma. In other words it arises not as a voluntary outgoing by the taxpayer, but as one imposed on the taxpayer once she has decided to pursue a certain course. There is another sense in which the expenditure is not voluntary. If the student wants to enter into private practice as a solicitor, she has to do the Legal Workshop or its equivalent in the other jurisdictions. The fee has to be paid to do the Workshop. The student's purpose in paying the fee is to enable her to study in the Workshop course and thus qualify for admission to the Supreme Court as a barrister and solicitor. Her ability to enter the course by paying the fee determines whether she earns assessable income in the form of AUSTUDY payments.

Hill J in *Studdert* suggested that purpose was not an appropriate consideration in characterising expenditure under s 51(1). Whether this is correct or not, neither the *Fletcher* approach nor the *Studdert* approach disadvantages the student in my example. The student is undertaking study and that study produces assessable income in the form of AUSTUDY. As a consequence of studying, there are certain almost unavoidable expenses that a student incurs. So the expenses are incurred in the course of gaining and producing assessable income and are allowable. If the purpose of the student in expending the money on fees is in any way relevant, it is to enable her to study and thus earn her income. This purpose does not in any way detract from deductibility.

For all of these reasons there does not appear to be an argument based on the purpose of the taxpayer that would allow apportionment of the expenditure.

⁸⁴ Ibid at 4957-4958.

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The Commissioner may also argue that the expenditure over and above the AUSTUDY received should be disallowed, because of the results it produces if allowed - a backdoor deduction for self-education expenses against non-related assessable income. This argument, which has some sort of superficial appeal, does not stand up to a more thorough analysis. The scheme of the Act can be found in s 48 (and s 17), coupled with the definitions of assessable income and allowable deductions in s 6. Tax is levied annually. It is paid at the appropriate rate (determined under a rating Act) on taxable income. Taxable income under s 48 is total assessable income less all allowable deductions.

So, for the student earning \$3,345 AUSTUDY during the first half of the 1997 income tax year and \$15,000 income as a solicitor during the second half, her total assessable income is \$18,345. The Legal Workshop fee of \$5,000 and materials charge of \$125 are allowable deductions (using the arguments outlined above) and so are deducted from the total assessable income of the year, irrespective of the particular source of the income which goes to make up that total amount. In those circumstances, to talk of a backdoor deduction for self-education expenses against future non-related income is to misunderstand the scheme of the Act. Once the self-education expenditure is characterised as a fully allowable deduction, then under s 48 it must be deducted from all assessable income for the year to arrive at the taxable income of the taxpayer. There can be no quarantining.

A similar argument applies in relation to deducting the loss against non-related income of future years. If the student had not been employed as a solicitor until the beginning of the next financial year (ie, 1 July 1997) then her total assessable income for the income year ended 30 June 1997 would be her AUSTUDY, namely \$3,345.⁸⁵ Her total allowable deductions would then be the Workshop fee and materials charge of \$5,125, leaving a loss of \$1,780.⁸⁶ Under s 79E of the Act, this excess of allowable deductions against assessable income - a (tax) loss - is able to be carried forward and offset against future assessable income. This tax loss of \$1,780 from the 1997 income year would then be able to be carried forward and deducted against assessable income - the \$30,000 salary income as a solicitor - earned during the income year ended 30 June 1998.

⁸⁵ Assume she did not receive any other income during that income year.

⁸⁶ Assume that she had \$250 other self-education expenses which are denied deductibility under s 82A.

In essence, s 79E converts the excess self-education expenses into something different, namely a tax loss. It is thus not correct to talk about this tax loss as being a backdoor way of allowing self-education expenses to be deductible against future non-related income. It is now a tax loss, not an excess self-education expense.

Interest

Now for a further complication. Assume that the student does not have the money to pay the \$5,000 fee. The University, in conjunction with the Commonwealth Bank, has generously established a loans scheme. Under that scheme, interest is charged at the campus rate, less 0.5%. The Campus Loan Rate is currently 9.8%.

No interest or capital repayments are required while the student is undertaking the program. However the accrued interest is added to the principal sum. Repayments begin six months after completion of the course, or sooner if the student wishes. Repayments are spread over a medium term period, normally three years.

Students who cannot find employment, and so cannot begin to repay, the interest and principal six months after the course finishes, can apply to the University for deferment of payments. In those circumstances, the University will arrange with the bank for repayments to be deferred for a further six months. The University will meet the interest payments on the loan during this further six month period.

In paragraph 48 of TR 92/8, the Commissioner informs us that interest incurred by a taxpayer on moneys borrowed to pay for self-education expenses is allowable under s 51(1), where the self-education expenses are themselves allowable. Thus it appears interest on a loan to pay the Legal Workshop fee will be deductible, because the fee itself will be deductible against AUSTUDY.

The problem is that the interest will not actually, in most cases, be offset against AUSTUDY. It will be claimed in later income years when it is actually paid, although the liability arose at an earlier date. For the student, that future income will not be related to the expenditure on Legal Workshop fees. From the point of view of s 51(1), that expenditure was incurred in the context of earning AUSTUDY, not earning income as a solicitor.

The fact that the interest is only incurred in later income years is not sufficient to deny deductibility. The interest arises from the loan.

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The loan was entered into for the purpose of paying the Legal Workshop fee, which is itself deductible. Interest is deductible on the basis of the use to which the loan is put. The interest therefore carries the stamp of deductibility with it when the obligation to pay it arises.

The Commissioner could argue that, because the activity (study in the Legal Workshop) which produces the income has ceased, no deductions should be allowed after the study finishes. There may be some support for this approach from the High Court in *Amalgamated Zinc (De Bavay's) Ltd v FCT*,⁸⁷ although the case itself dealt with the cessation of business. Its principle seems to be that, if a business ceases or changes, then ongoing expenses which arose out of the original business are no longer deductible because they are not related to earning the assessable income in later years. However, it is clear that later judicial developments have rendered this approach inappropriate.

The question of the temporal relationship between expenditure and income has been raised in the context of the use of the phrase "the assessable income" in s 51(1). It is clear that phrase does not mean assessable income of the year in which the expenditure was incurred.⁸⁸ The second limb of s 51(1) - the business deduction limb - refers to losses or outgoings necessarily incurred in carrying on a business for the purpose of gaining or producing such income. The phrase "such income" is a reference back to the words "the assessable income" in the first limb of s 51(1). It has been interpreted to refer:

not to the assessable income of the accounting period but to assessable income generally. If they were so interpreted, they would cover a case where the business had not yet produced or had failed to produce assessable income and the alternative would then itself suffice to authorise the deduction of the loss made in a distinct business.⁸⁹

Of course, that applies where income occurs at a future date after the expenditure has been incurred, but there appears to be no logical reason why this temporal disconnection between assessable income and deductions should stand in the way of deductions which occur some time after the particular activity which produces assessable

⁸⁷ (1935) 54 CLR 295.

⁸⁸ *Finn v FCT* (1961) 106 CLR 60 at 68 per Dixon CJ.

⁸⁹ *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 at 56.

income has ceased. For example, in *AGC (Advances) Ltd v FCT*⁹⁰ Mason J said:⁹¹

It is inconceivable that Parliament intended to confine deductions 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.

In *Placer Pacific Management Pty Ltd v FCT*⁹² the Full Federal Court described the decision in *AGC* as:⁹³

establishing the proposition that provided the occasion of a business outgoing is to be found in the business operations directed towards the gaining or production of assessable income generally, the fact that the outgoing was incurred in a later year in which the income was incurred⁹⁴ and the fact that in the meantime business in the ordinary sense may have ceased will not determine the issue of deductibility. 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, that loss or outgoing will be deductible unless it is capital or of a capital nature.

The Court in *Placer Management* commented that it was unnecessary to decide whether the same result (ie, allowing deductions in later years after the particular activity which occasioned the deductions has ceased) would arise under the first limb of s 51(1) in a case where the taxpayer carried on no business activity.⁹⁵

However, there seems no reason in principle why this approach should only apply to business operations. If the occasion for the expenditure is in the activities directed to gaining or producing assessable income (such as studying and as a consequence receiving AUSTUDY) then outgoings (for example, of interest on money borrowed to pay the Legal Workshop fee) should be deductible, irrespective of the income year in which they are finally incurred. Based on the broad principle coming from *Placer Management*, interest incurred in later income years, as a consequence of borrowings

⁹⁰ 5 ATC 4057.

⁹¹ Ibid at 4071.

⁹² 95 ATC 4459.

⁹³ 95 ATC 4459 at 4464.

⁹⁴ I assume this should in fact be a reference to "earned" rather than "incurred".

⁹⁵ Ibid at 4465.

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made to pay the Legal Workshop fee, will be deductible under the first limb of s 51(1) for students who received AUSTUDY during their time at Workshop.

AUSTUDY supplement

A final complication can be found in the option students have to convert some of their AUSTUDY into a loan. This is known as the AUSTUDY Supplement. A student can give up between \$250 and \$3,500 of their AUSTUDY entitlement. In return, the student will get double the amount given up, ie, between \$500 and \$7,000 in the form of a loan from the Commonwealth Bank. Thus, a student on \$6,000 AUSTUDY who gives up \$3,500 would receive annual payments of \$9,500, which is nearly \$364 per fortnight. The loan is supposedly interest free, but the repayment amount is indexed in line with CPI, effectively an interest charge. Students do not have to make any repayments on the loan for five years, and then they only have to do that if their taxable income is more than average earnings. For the 1994/95 income year that figure was \$26,852.

Deductions against AUSTUDY Supplement are not allowable. The AUSTUDY Supplement is not subject to income tax, even though it is paid in fortnightly amounts. It is a capital amount, being a loan. If that is the case, then expenditure related to the AUSTUDY Supplement cannot be allowable because it is not incurred in gaining or producing assessable income. Thus, if a student surrenders all her AUSTUDY entitlement in return for AUSTUDY Supplement, she will not be entitled to any deductions.

There is an argument that, because it is paid regularly to enable the student to meet living expenses, the Supplement is income. Even if that is the case, s 12ZR of the Student and Youth Assistance Act 1973 says that an amount paid under the Student Financial Supplement Scheme is not subject to taxation under any law of the Commonwealth, unless a provision of such a law expressly provides to the contrary. No such law has expressly provided that the AUSTUDY Supplement be subject to taxation, so that, even if it is income, it is exempt income and expenditure incurred in gaining or producing exempt income is not allowable under s 51(1).

But what is the situation if the student keeps a few dollars a year of AUSTUDY and converts the rest to AUSTUDY Supplement? First, will they be entitled to deduct all their self-education expenses against the few dollars of AUSTUDY assessable income? Should

there be some sort of apportionment? And if the self-education expenses are far greater than the few dollars retained as AUSTUDY, might the Commissioner not invoke *Fletcher* and look at the taxpayer's purpose, not just in spending the money on fees, books and the like, but also in retaining a few dollars of AUSTUDY?

If the Commissioner can look at the arrangement in this wider context, might he not conclude that the taxpayer's purpose in keeping a few dollars of AUSTUDY was to enable the student to deduct self-education expenses rather than something to do with the income-earning activity? On that basis the Commissioner might then apportion the deductions so that they are only allowable up to the level of the AUSTUDY actually received, namely a few dollars a year.

On the basis of the uncertainty outlined above associated with AUSTUDY Supplement, from a tax point of view students would be well advised to think very carefully before taking up the Supplement, at least in those circumstances where the self - education expenses are very large and all, or almost all, of AUSTUDY is converted to a loan.

Conclusion

Section 51(1) is a complex provision both in its wording and application. However, it appears from this investigation of the operation of the provision and the deductibility of self-education expenses that fees of the magnitude of those imposed by the various universities (including the Australian National University) on Legal Workshop students will be deductible against AUSTUDY and other income earned in the income year. Any tax loss that may arise will be able to be carried forward and offset against future assessable income.