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Deductibility

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EDITORIAL

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The Dixon High Court, with clarity of thought and expression, laid down pivotal principles of Australian taxation law. Building on the work of the Latham Court, in which Dixon was a powerful performer, Dixon's High Court settled the elements of assessable income (*FCT v Dixon* (1952)) and of deductibility of business expenses (*Ronpibon Tin NL v FCT* (1949); *Cecil Bros v FCT* (1963); *Lunney and Hayley v FCT* (1958); *Finn v FCT* (1960)).

The Barwick CJ High Court's approach to tax interpretation almost gave a bad name to the unbreakable rule that the tax laws must accurately say what they mean and, if there be ambiguity, that it be resolved in favour of the taxpayer.

Powerful intellect that he was, Barwick CJ carried the Privy Council along and helped Lord Diplock to write a terrible tax deductibility test. It is below, to be seen but not read.[1] Those words, and others of Barwick CJ, encouraged taxpayers, lawyers and accountants to tailor and sculpt the form of a transaction and hide the substance.

The unintended effect of this was not the dreadful Part IVA and all that, but instead what happened to the most important, or second most important, provision in the tax Act – the deductions provision, now found in s 8-1.

Section 8-1 says with admirable clarity: *"you can deduct … any loss or outgoing to the extent that it is incurred in gaining or producing your assessable income..."*

[1] '[I]s the legal effect - as distinct from the economic consequences - of the provisions of the relevant interrelated contracts such that, then the taxpayer company orders goods under the contract of sale and accepts the obligation to pay the sum stipulated in that contract as the purchase price, the taxpayer company by the performance of that obligation acquires a legally enforceable right not only to the delivery of the goods but also to some other act performed which confers a benefit in money or money's worth upon the taxpayer company or some other beneficiary?' *Europa Oil (NZ) Ltd (No 2) v C of IR (NZ)* [1976] 1 All ER 503, 509; [1976] 1 NZLR 546.

In 1981, the High Court was asked whether home study costs should be deductible. If you were a teacher or lawyer and rented your home, and used one of your bedrooms for your home study, could you deduct that room's portion of the rent, etc?

The correct answer would have been yes. That is what Dixon CJ would have said (it was what Stephen J said; and probably what Brennan CJ would have said, too). If you spent money as rent to get a room for a study in which you earned income, you were entitled to deduct that room's proportion of the rent.

But the High Court majority said no.[2] It said a room in a home had one character or the other. It could be an office or it could be a bedroom, but not both. The Court said, if its 'essential character' was as a bedroom, then there was no deduction. Even if you used the bedroom as a study into the small hours of the morning, marking exam scripts or writing learned opinions.

The High Court had invented and read into the Act what it called a 'characterization test'. The Court asked that you search for '*the* true legal character' of an expenditure. A granny flat could not *also* be an office.

This was curious because, right there in s 8-1, were the words 'to the extent to which'. You could claim an expenditure to the extent that it was incurred in earning assessable income. That means if you use what is usually the dining room as an office for 25% of the time, then you can claim 25% of the room's costs.

Anyway, the second argument here is that the test for deductibility under s 8-1 has to be the purpose test. What is the purpose for which you made that expenditure? If your purpose were to earn income, then you can deduct the expenditure. If not, then you can't.

There is no other way successfully to test for the link or nexus between the expenditure and the income it earns. So, when the Act says the expenditure must be 'incurred in' earning income, it means *incurred for the purpose of* earning income. Is your expenditure on that law book or that taxi ride deductible? Yes, because it was incurred for the purpose of advising a client or seeing a customer and thence earning income.

2 *Handley v FCT* (1981) 148 CLR 182 and *Forsyth v FCT* (1981) 148 CLR 203.

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Further - if benefit this be - a purpose test for deductibility discourages tax avoidance. If a client is asked the purpose of her dodgy expenditure,[3] and her answer is something other than the earning of assessable income (eg, if she were to say 'to lower my tax' or 'to provide a home for mum'), then you do not have a deductible expenditure. If she has two purposes (eg, to earn assessable income *and* to provide a home for mum) then you (or the court) can apportion fairly enough between these two purposes. That's what the Act calls for - apportionment – when it uses the words 'to the extent to which'. It is a workable approach.[4]

Dubious schemes to avoid tax rely on dodgy deductions, much of the time. If the purpose test for deductibility applied, those schemes would not work. The expenditures in the schemes would bristle with purposes other than the purpose of earning assessable income. So the deductibility would not be there to make the schemes work.

So, a suggestion – that the word 'purpose' be written into s 8-1.[5]

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[3] Expenditures (and resultant deductions) seem dodgy for the very reason that we know full well what their purpose is – and it has little to do with earning assessable income.

[4] This apportionment according to purpose would have knocked *FCT v Phillips* 78 ATC 4361 into shape. See, generally, Evelyn Khoo, 'The Implications of *Fletcher v FCT*' (1993) 3 *Bond Law Review* 63. Ms Khoo laments that the tests for deductibility overlap and are difficult to use. She argues for a straight forward interpretation of s 8-1 – using the purpose test.

[5] No one should suggest adding one word to the tax statutes without also suggesting the removal of two. In this spirit, in return for the insertion of this one word ('purpose') we recommend the removal of Part IVA entirely.