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Abstract
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Keywords
Statutory interpretation, necessarily incurred, substantially incurred, essential character, relevant and incidental test necessary but not sufficient condition, categories of exclusion, absolute and non-absolute, private or domestic expenditure in s8-1(2)(b)

IS SECTION 8-1(2)(B) INOPERATIVE?

DANIEL DIAZ*

Exclusions of otherwise deductible losses or outgoings can be categorised according to the mechanism of their application to a taxpayer's circumstances. Analysis of decisions regarding deductions where s 8-1(2)(b) appears relevant reveals that s 8-1(2)(b) is merely a restatement of the principles underlying s 8-1(1). As a result, s 8-1(2)(b) is effectively inoperative.

INTRODUCTION

A general deduction provision, such as s 8-1, has been a feature of Australian income tax law since its inception.[1] Further, it has always been a feature of that provision that expenditure of a private or domestic nature is excluded from deductibility. In the *Income Tax Assessment Act 1997* (***ITAA97***), this exclusion is found in s 8-1(2)(b). Recently, the exclusion has been considered by the High Court in *FCT v Anstis.*[2] Some authors have suggested that the exclusion has been relied upon or is necessary to exclude certain losses or outgoings.[3] The relationship between s 8-1(1) and the exclusion has not been considered in great detail. However, consideration has been given as to whether a scheduler deductions framework should be implemented to ensure that inappropriate exclusions of 'private or domestic' outgoings does not occur.[4] Similarly, the Australian Taxation Office's (***ATO***) position is that the exclusion is a definite and absolute exclusion of certain expenditure.[5]

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1 *Income Tax Assessment Act 1922* (Cth).

2 (2010) 241 CLR 443, 459.

3 Jeffrey Waincymer, *Australian Income Tax Principles and Policy* (Butterworths, 1991) 203; Stan Ross and Philip Burgess, *Income Tax: A Critical Analysis* (Law Book Company, 1991) 110-111.

4 Phillip Burgess, 'Section 51 and Personal Expenditure' (1980) 9 *Australian Taxation Review* 217, 228.

5 The ATO's position is seen through a series of publications regarding the deductibility of expenditure incurred by certain classes of taxpayers. For example the ATO has, in relation to Australia Defence Force personnel stated that compulsory messing expenditure referable

The exclusion became effectively inoperative because of the adoption of the 'essential character' test as stated in *Lunney v FCT*.[6] The Full Federal Court decisions in *Edwards v FCT*[7] and *FCT v Cooper*[8] illustrate this. These decisions considered the deductibility of additional outgoings on clothing, and food and drink respectively; items that would ordinarily be considered private and domestic by their very nature yet in the case of *Edwards* a deduction was allowed. The decisions affirmed a proposition that once an outgoing satisfies a positive limb of s 8-1(1) it is impossible for the outgoing to be excluded under s 8-1(2)(b). However, in earlier decisions, the courts have held that there is no reason as to why a loss or outgoing that satisfies s 8-1(1) may nevertheless be excluded by s 8-1(2)(b). Therefore, situations should exist where a loss or outgoing is incurred in the course of gaining or producing assessable income yet is denied deductibility on the basis of being of a private or domestic nature. Closer analysis though, reveals that s 8-1(2)(b) is incapable of excluding outgoings that otherwise satisfy s 8-1(1). This proposition is testable by examining the key concepts underlying s 8-1(1), establishing a framework describing the operative mechanism of exclusions to deductibility and then, analysing decisions where s 8-1(2)(b) was relevant (based on the subject matter of claimed deductions), to determine whether s 8-1(2)(b) builds upon s 8-1(1). Essentially, the proposition is tested by trying to determine whether expenditure can satisfy s 8-1(1) yet fall foul of s 8-1(2)(b).

FRAMEWORK OF SECTION 8-1

Section 8-1 comprises two separate yet equally important aspects. It is described as comprising of positive limbs and negative limbs.[9] The positive limbs of s 8-1 require that an outgoing has a connection with producing assessable income. The loss or outgoing must be incurred in gaining or producing assessable income[10] or the loss must be necessarily incurred in carrying on a business for the purpose of gaining or

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to food and drink is not deductible as it is of a private nature (Australian Taxation Office, *Income Tax: Employee work related deductions of employees of the Australian Defence Force*, TR 95/17, 31 March 1999, [159]). The ATO has also held that expenditure outlaid to purchase swimming clothes by a swimming instructor is not deductible on the basis that such clothing is 'conventional clothing' (Australian Taxation Office, *Income tax: Deductions: Swimming instructor* ATO ID 2010/164, 14 September 2010). In both instances the ATO appears to rely on s 8-1(2)(b) to exclude expenditure that is believed to be otherwise deductible.

6 (1958) 100 CLR 478.

7 (1994) 49 FCR 318.

8 (1991) 29 FCR 177.

9 Robin Woellner, Stephen Barkoczy, Shirley Murphy, Chris Evans and Dale Pinto, *Australian Taxation Law* (CCH, 20th ed,2010), 565.

10 *Income Tax Assessment Act 1997* (Cth) s 8-1(1)(a).

producing assessable income.[11] As both limbs share the root of 'gaining or producing assessable income', both limbs share a common test of 'essential character'. However, s 8-1(1)(b) captures a broader range of expenditure. The negative limbs of s 8-1 prohibit a taxpayer from deducting certain losses or outgoings notwithstanding that loss or outgoing satisfies s 8-1(1). The negative limbs exclude losses or outgoings that are capital or capital in nature, private or domestic or of such character, incurred in producing exempt income and otherwise specifically denied deductibility under another provision.[12]

The test developed regarding s 8-1(1) is whether the loss or outgoing has the 'essential character' of a loss or outgoing incurred in gaining or producing assessable income.[13] This test has evolved from the earlier test of 'relevant or incidental expenditure' which was formulated by the High Court.[14] Further, at times alternative tests have been applied when considering particular fact patterns, especially when considering the deductibility of interest payments.[15]

Ronpibon Tin NL v FCT[16] formulated the 'relevant or incidental' test of s 8-1(1). The Court considered the deductibility of payments made by a mining company to families of its employees interned by Japanese forces during the Second World War; the company did not operate the mines at the time due to Japanese occupation. In determining whether the expenditure was incurred in gaining or producing assessable income the Court considered the connection between the expenditure and income production, holding that:[17]

> … to come within the initial part of [section 8-1(1)] 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 Court expanded on Dixon J's [as he then was] judgment in *Amalgamated Zinc (De Bavay's) Ltd v FCT*.[18] There, Dixon J held that an outgoing was deductible if the

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11 Ibid s 8-1(1)(b).

12 *Income Tax Assessment Act 1997* s 8-1(2).

13 See for example; *Lunneyv FCT* (1958) 100 CLR 478 where the High Court considered the deductibility of fares paid to travel to work.

14 The test was set out in *Ronpibon Tin NL v FCT* (1949) 78 CLR 47 where the High Court considered the deductibility of payments made in relation to interned employees of a mine during the Second World War.

15 Grant Richardson, 'Section 51(1): Unlegislated Tests of Deductibility' (1995) 24 *Australian Taxation Review* 153, 167.

16 (1949) 78 CLR 47.

17 (1949) 78 CLR 47, 57 (emphasis added).

18 (1935) 54 CLR 295.

occasion for the outgoing was found in an activity productive of income or expected to produce income.[19] The occasion of the outgoing did not require direct relevance to the production of income as the outgoing could be a preceding or related outlay regarding income producing activity.[20]

The High Court expanded the scope of 'relevance' in *W Nevill and Company Ltd v FCT*[21] where it considered the deductibility of director termination fees. Latham CJ expanded on *Amalgamated Zinc*, holding that such fees were deductible as "…the expenditure was an outgoing whose purpose was to increase the efficiency of the company and increase its income producing capacity."[22] As a result, the taxpayer was not required to show the connection between actual income produced and the outgoing but rather the purpose of increasing efficiency and income producing capacity.[23]

The test of 'relevant and incidental' may be characterised as a broad test capturing expenditure showing a relation to income production. As noted in *Amalgamated Zinc*, the test ordinarily results in a deduction not being available where the loss or outgoing followed the cessation of income production,[24] however, in circumstances where a taxpayer is in the process of ceasing business operations deductions may still be available.[25] The High Court, however effectively rejected the 'relevant and

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19 Ibid, 309.

20 Ibid, 309 where Dixon J held that 'The expression "in gaining or producing" has the force of "in the course of gaining or producing" and looks rather to the scope of the operations or activities and the relevance thereto of the expenditure than to purpose itself.".

21 (1937) 56 CLR 290.

22 Ibid 300.

23 Ibid. Latham CJ relied on *British Insulated and Helsby Cables v Atherton* (1926) AC 205, 212 where Viscount Cave LC's stated "A sum of money spended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade." Whilst the principle Viscount Cave LC stated related to the idea of 'expended wholly and exclusively for the purposes of the trade, Latham CJ considered that the concept was analogous to 'in gaining or producing assessable income'. Latham CJ continued holding that 'The words in sec. 23(1)(a) are "in gaining or producing the assessable income." The principle asserted in Viscount Cave's statement is, however, equally applicable to a case arising under sec. 23(1)(a).'

24 (1935) 54 CLR 395, 304.

25 The judgment of Davies, Hill and Sackville JJ in *Placer Pacific Management Pty Ltd v FCT* (1995) 31 ATR 253 consider comprehensively authorities regarding post cessation losses or outgoings and the distinction between such losses and outgoings as compared to losses and outgoings incurred during a period of temporary cessation of income production.

incidental' test as an exclusive test of deductibility in *Lunney v FCT*.[26] There the High Court considered the deductibility of bus fares incurred by a taxpayer in travelling to work. Dixon CJ noted that the 'relevant or incidental' test, as expounded in *Ronpibon Tin* and later expanded,[27] was inadequate to deal with the expenditure in question and instead relied on established authorities to hold that the fares were not deductible.[28] Dixon CJ's analysis was disappointing given the decision of *Lodge v FCT*,[29] which, like *Lunney*, considered expenditure necessary to commence work and in neither case were the fundamental principles regarding the general deduction provision seriously considered.[30] Williams, Kitto and Taylor JJ addressed the matter and moved away from the 'relevant or incidental' test in *Ronpibon Tin* by holding that:[31]

> … the expression "incidental and relevant" was not used in an attempt to formulate an exclusive and exhaustive test for ascertaining the extent of the operation of… [section 8-1(1)]; the words were merely used in stating an attribute without which an item of expenditure cannot be regarded as deductible under the section.

Kitto, Williams and Taylor JJ held that expenditure must be relevant or incidental but that this was merely a necessary but not sufficient condition.[32] In doing so their Honours rejected the 'relevant or incidental' test set out in *Ronpibon Tin*. This was because in *Ronpibon Tin*, it was held that relevance or incidence was both necessary and sufficient in respect of deductibility. Their Honours' formulation required that, in addition to being relevant or incidental, the deductibility of a expenditure will turn "… upon considerations which are concerned with the essential character of the expenditure itself."[33] Thus, the test of deductibility instead focussed on the question

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26 (1958) 100 CLR 478.

27 Ibid 482 where Dr F Louat QC for the taxpayer submitted that the authorities of *Ronpibon Tin*, *Amalgamated Zinc*, *W Nevill & Co* and *Charles Moore* enunciated the general test of deductibility set out by the general deduction provision that were applicable in determining whether expenditure regarding bus fares was deductible.

28 Ibid 486-7 where Dixon CJ relied on the decisions of *Re Adair* (1898) ALR (CN) 42 and *Re Income Tax Acts* (1903) 29 VLR 298 stating that "I confess for myself, however, that if the matter were to be worked out all over again on bare reason, I should have misgivings about the conclusion. But this is just what I think the Court ought not to do. It is a question of how an undisputed principle applies. Its application was settled by old authority long accepted and always acted upon."

29 (1972) 128 CLR 171.

30 I C F Spry, 'Outgoings of a Private or Domestic Nature' (1973) 2 *Australian Taxation Review* 54, 55.

31 (1958) 100 CLR 478, 497.

32 Ibid.

33 Ibid.

of whether the expenditure could be considered to have the essential character of deductible expenditure.

The essential character test has subsequently been applied and adopted both implicitly,[34] as well as explicitly, as seen in *Cooper* where Lockhart J held:[35]

> The deductibility of the outgoing depends upon determining the essential character of the outgoing itself and not upon the fact that, unless it is incurred, the taxpayer will not be able to engage in the activity from which his income is derived.

Although in that same decision Wilcox J highlighted the essential character test presented difficulties of its own as it begged the critical question.[36] That is, the essential character test could pre-determine its own outcome based upon the facts which were considered in determining whether expenditure had the requisite essential character. Wilcox J held that the test required consideration of all the relevant circumstances to determine whether the loss or outgoing had the requisite essential character. [37]

Charles Moore v FCT[38] suggests that a larger range of losses or outgoings may have the requisite essential character under s 8-1(1)(b) as compared to where 8-1(1)(a) is relied upon. In that decision, the Court considered losses due to robbery while banking sales cash and cheques by a business holding that:[39]

> [banking the business' sales] is an essential… part of the conduct of the business, a necessary or recognised incident or concomitant, and is relevant as incidental to the end in view, the gaining of assessable income.

Accordingly, s 8-1(1)(b) is capable of capturing activities that do not of themselves gain or produce income but are a step preparatory or antecedent to the gaining or production of income where that action is in the course of conducting a business.

Second, s 8-1 contemplates apportionment through the phrase 'to the extent that'.[40] How apportionment is determined is important because if it occurs on the basis of dividing the entire benefit of an outgoing into deductible and non-deductible components, then s 8-1(2)(b) is effectively inoperative. For example, in the absence of

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34 *Magna Alloys & Research Pty Ltd v FCT* (1980) 11 ATR 276.

35 (1991) 29 FCR 177, 184.

36 Ibid 187.

37 Ibid 188.

38 (1956) 95 CLR 344.

39 Ibid 350.

40 See also; *Ure v FCT* (1981) 11 ATR 484

an express exclusion,[41] taxpayers who incurred expenditure in providing a meal to entertain a client would be entitled to entirely deduct that expenditure notwithstanding that part of the meal served a non-deductible purpose by nourishing the taxpayer and their client. Parsons considers the same scenario using the example of a taxpayer undergoing surgery enabling them to return to work. Parsons concludes that apportionment is not appropriate in such instances because the apportionment aims separate out multiple incidental purposes to a loss or outgoing from what is in effect a single outgoing that is not dissectible.[42] Further, judicial consideration supports the proposition that such apportioning is not possible. This is seen in both *Magna Alloys & Research Pty Ltd v FCT*[43] and *Ure v FCT*[44] which held that apportionment can occur only where a loss or outgoing can be dissected into separable parts.

Ure considered a taxpayer who borrowed money at high rates of interest and then loaned that money to a related party at very low rates of interest.[45] The money was ultimately used to discharge a mortgage on the taxpayer's principal place of residence and to acquire a further residence. The taxpayer made further borrowings and loaned that money at a low rate of interest to a company controlled by the taxpayer to obtain financial products.[46] The Court's task was to determine whether the taxpayer was entitled to deduct the interest they paid regarding the loan monies. Brennan J held that the taxpayer was not entitled to a deduction for the entire amount of interest on the basis that "If the borrowed moneys had been laid out solely for the purpose of gaining or producing assessable income, the interest would be wholly deductible."[47] However, Brennan J identified four purposes regarding the outlay of the loan monies; to discharge the mortgage over his previous principal place of residence, to acquire a new residence, to obtain financial products, and to obtain a return of 1% interest through the on-lending. Brennan J held that the expenditure could be dissected and that interest was deductible only to the extent that the money was obtained to return 1% interest.[48] Sheppard and Deane JJ delivered a joint judgment to the same effect as Brennan J. They held that

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41 Section 32-5 of the *Income Tax Assessment Act 1997* (Cth) provides for a general prohibition on the deduction of 'entertainment' expenses incurred by a taxpayer. Further, Division 32-B of that Act provides for exclusions to this general prohibition.

42 R W Parsons, *Income Taxation In Australia: Principles of Income, Deductibility and Tax Accounting* (Law Book, 1985) 484.

43 (1980) 11 ATR 276.

44 (1981) 11 ATR 484.

45 Ibid 485-6.

46 Ibid 487.

47 Ibid 489.

48 Ibid 491.

apportionment was available because the lending could be dissected into two components: first, obtaining of a 1% return on the money and secondly to acquire the otherwise non-deductible objects.[49] They held that as a general rule: [50]

> The fact that money is re-lent at a lower rate of interest than the rate at which it was borrowed does not necessarily mean that the liability to pay the interest cannot properly be seen as having been incurred wholly in earning the assessable income…

The holdings suggest that the quantum of assessable income derived from a loss or outgoing is an irrelevant consideration of deductibility. Rather the purposes of the expenditure are the relevant matters when considering apportionment.

Magna Alloys further demonstrates the limitations of apportionment. The case concerned the deductibility of legal expenditure incurred by a company in defending its directors and agents regarding the payment of secret commissions.[51] Brennan J noted that outgoings such as these, like the business lunch, serve two purposes; first, the outgoing was incurred to defend Magna Alloys' reputation and secondly, the outgoing secured a defence for Magna Alloys' agents and directors. It was apparent that that first purpose satisfied s 8-1(1) whilst the second purpose did not. In circumstances such as this Brennan J held that:[52]

> … the expenditure bears the character of expenditure necessarily incurred… The character of the expenditure is not lost because the expenditure was apt to serve both the business purpose and the purpose of defending the directors…

Similarly, Deane and Fisher JJ noted that where an outgoing serves multiple simultaneous purposes the "… fact that the business advantage sought is indirect or remote will not of itself preclude the pursuit of that advantage from characterizing the outgoing as an outgoing necessarily incurred in carrying on that business"[53] Further, where outgoings serves a non-deductible purpose entwined with a deductible purpose then the deductible purpose will satisfy s 8-1(1) notwithstanding the existence of the non-deductible purpose.[54]

Therefore, the concept of apportionment is important as the following conclusions can be drawn. First, once expenditure is marked with a deductible purpose it is captured by s 8-1(1), any incidental benefit it provides that cannot be separated out is not fatal to claiming the deduction. Secondly, as a consequence of the first conclusion,

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49 Ibid 493.

50 Ibid.

51 (1980) 11 ATR 276, 278.

52 Ibid 288.

53 Ibid 296.

54 Ibid 298.

it is insufficient to say that s 8-1(2)(b) and s 8-1(1) co-exist on the basis that s 8-1(2)(b) carves out entwined incidental benefits attached to deductible outgoings. Accordingly, it is necessary to consider s 8-1(2)(b) on its own merit and whether it places a further hurdle on outgoings or losses satisfying s 8-1(1).

CATEGORISING EXCLUSIONS UNDER SECTION 8-1(2)

Section 8-1(2) excludes losses that are; capital or of a capital nature;[55] private or domestic;[56] incurred in producing of exempt income or non-assessable non-exempt income (***NANE income***),[57] or are specifically denied deductibility under another provision of the ITAA97.[58] The exclusions can be categorised based on their interaction with s 8-1(1). As a result, the exclusions can be categorised as either: an absolute exclusion, a non-absolute exclusion or a non-excluding exclusion. These categories conceptually cover the field of possible exclusions.

ABSOLUTE EXCLUSIONS

Absolute exclusions exclude deductions irrespective of the taxpayer's circumstances. Sections 26-20, 26-53 and 26-54 of the ITAA97 are examples of absolute exclusions. Respectively, these sections deny deductions for; student assistance repayments, payment of bribes and outgoings or losses relating to illegal activities. Section 26-54 best demonstrates the operation of an absolute exclusion. Section 26-54 states:[59]

> You cannot deduct under this Act a loss or outgoing to the extent that it was incurred in the furtherance of, or directly in relation to, a physical element of an offence against an Australian law of which you have been convicted if the offence was, or could have been, prosecuted on indictment.

Section 26-54 was enacted as a response to *FCT v La Rosa*[60] to prevent similar deductions being made in the future.[61] The Court in *La Rosa* held that robbery losses connected with an illegal business were deductible. The taxpayer submitted that the deduction was analogous to *Charles Moore* whilst the Commissioner submitted that the ITAA97 implicitly denied deductions tainted by illegality. The Court rejected the Commissioner's submissions, holding that:[62]

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55 *Income Tax Assessment Act 1997* (Cth) s 8-1(2)(a).

56 Ibid s 8-1(2)(b).

57 Ibid s 8-1(2)(c).

58 Ibid s 8-1(2)(d).

59 Ibid s 26-54.

60 (2003) 129 FCR 494.

61 Explanatory memorandum, *Income Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005*, [6.3]-[6.5].

62 (2003) 129 FCR 494, 508.

> …the purpose of the *Income Tax Assessment Act* is to tax taxable income, not to punish wrongdoing… There should not be a higher burden of taxation imposed on those whose business activities are unlawful than that imposed in relation to lawful business activities.

The Commissioner was unsuccessful in obtaining special leave to appeal the above point.[63]

Section 26-54 is an absolute exclusion. Prior to its enactment, once expenditure satisfied s 8-1(1) a deduction was available even if the outgoing was related to illegal activities. However, s 26-54 denies deductibility of such expenditure notwithstanding that such expenditure satisfies s 8-1(1). This is so regardless of whether an outgoing is itself illegal or whether it is legal yet related to an illegal business.[64] Sections 26-52 and 26-53 of the ITAA97 impose similar exclusions for outgoings for the purposes of bribing public officials. The minister's second reading speech noted that the objective of sections 26-52 and 26-53 was to implement OECD[65] recommendations and deny deductions that would otherwise be available where a taxpayer bribed a public official in the course of income producing activities.[66]

Three propositions can be deduced regarding absolute exclusions. First, an absolute exclusion denies a deduction to all taxpayers even if a taxpayer can show that an outgoing has the essential character of being incurred producing assessable income. Second, an absolute exclusion denies a deduction regardless the subjective facts surrounding the outgoing in the context of the taxpayer's income producing activities. Third, an absolute exclusion builds upon s 8-1(1) as it reduces the field of deductions that are otherwise allowed by s 8-1(1).

NON-ABSOLUTE EXCLUSIONS

Non-absolute exclusions are exclusions that operate according to a taxpayer's subjective circumstances. Section 8-1(2)(a) is an example of such an exclusion. Section 8-1(2)(a) is a non-absolute exclusion because what is considered a capital loss or capital outgoing varies from taxpayer to taxpayer. For example, a taxpayer who buys and sells securities in a business of trading securities can claim a deduction for the cost of acquiring securities whilst a taxpayer buying and selling securities to obtain a stream of income cannot because such expenditure is capital expenditure in their circumstances.[67]

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63 [2004] HCATrans 420 (27 October 2004, Hayne and McHugh JJ).

64 Phillip Burgess, 'Deductions and Illegal Income' (2008) 37 *Australian Taxation Review* 7, 12.

65 Organisation of Economic Co-Operation and Development.

66 Commonwealth, *Parliamentary Debates*, Senate, 29 September 1999, 9174, (Ian Campbell).

67 ATO ID 2001/745; *AAT Case 6297* (1990) 21 ATR 3747.

Questions arise as to whether a non-absolute exclusion contributes substantially to s 8-1, that is, does the exclusion raise a line of enquiry beyond determining whether a loss or outgoing has the essential character of being incurred in gaining or producing assessable income. In the case of s 8-1(2)(a) it is clear that the exclusion raises a fresh enquiry. Early decisions of the High Court show that a number of tests were adopted to determine whether expenditure was capital expenditure. However, beginning with Dixon J's analysis in *Sun Newspapers Ltd v FCT*,[68] a systemic approach began to be developed to determine the character of expenditure. *Sun Newspapers* considered whether payments made by Sun Newspaper to stifle competition in the newspaper printing business was capital expenditure. Dixon J held that:[69]

> The distinction between expenditure and outgoings on revenue account and on capital account corresponds with the distinction between the business entity, structure or organization set up or established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay.

Dixon J considered that three factors were relevant when determining whether an outgoing or loss related to the business entity, structure or organization, these being:[70]

> (a) the character of the advantage sought… (b) the manner in which it [the advantage] is to be used, relied upon or enjoyed… and (c) the means adopted to obtain it…

Dixon J's test was subsequently adopted by the High Court in *Hallstroms Pty Ltd v FCT*.[71] Latham CJ closely followed Dixon J's reasoning in *Sun Newspapers*[72] whilst Dixon J moved forward and distilled *Sun Newspapers* noting that:[73]

> …contrast between the two forms of expenditure [capital and revenue] corresponds to the distinction between the acquisition of the means of production and the use of them, between establishing or extending a business organization and carrying on the business, between the implements employed in work and the regular performance of the work in which they are employed, between the enterprise itself and the sustained effort of those engaged in it.

Dixon J's test in *Sun Newspapers* was again applied by the High Court in *Broken Hill Theatres Pty Ltd v FCT*.[74] The case considered whether legal fees paid for the purpose

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68 (1938) 61 CLR 337.
69 Ibid 359.
70 Ibid 363.
71 (1946) 72 CLR 634.
72 Ibid 641-2.
73 Ibid 647.
74 (1952) 85 CLR 423.

of limiting competition were deductible. Dixon CJ, McTiernan, Fullagar and Kitto JJ applied *Sun Newspapers* but with the qualification that of the three criteria considered in *Sun Newspapers*, it was not necessary for all three to be present to indicate an outgoing was capital or of a capital nature.[75]

In *BP Australia v FCT*[76] the Privy Council considered the deductibility of payments made by BP Australia to secure exclusive distribution rights amongst petrol retailers, the Privy Council was primarily concerned with matters relating to the advantages the payments secured; Lord Pearce applied *Sun Newspapers* in a detailed fashion.[77] In all three cases; *BP Australia, Sun Newspapers* and *Broken Hill Theatres* the connection of the outgoings with income production was not in issue. Rather the issue raised was whether, in the context of the taxpayer's activities, was the expenditure referable to the taxpayer's business structure or asset base. Accordingly, the examples illustrate how a non-absolute exclusion operates to exclude otherwise deductible expenditure by reference to criteria beyond merely the connection of incurring expenditure with income production.

In summary, a non-absolute exclusion exists where the exclusion operates by reference to the particulars of a taxpayer's circumstances. Second, the operation of the exclusion can cause expenditure to be denied deductibility in the hands of certain taxpayers as compared to others based on these circumstances. Third, a non-absolute exclusion adds substantially to s 8-1 because the exclusion introduces a further hurdle for taxpayers, despite a taxpayer satisfying s 8-1(1) it may yet be possible for the taxpayer to run foul of the non-absolute exclusion.

EXCLUSIONS FAILING TO EXCLUDE LOSSES OR OUTGOINGS (EFFECTIVELY INOPERATIVE EXCLUSIONS)

The final category of exclusions are those that fail to exclude any losses or outgoings that satisfy s 8-1(1). Section 8-1(2)(c) is an example of such an exclusion where it states:[78]

> … you [a taxpayer] cannot deduct a loss or outgoing [under s 8-1] to the extent that it is incurred in relation to gaining or producing your exempt income or your non-assessable non-exempt income.

Exempt income and NANE income are defined by Division 6 of the ITAA97.[79] Those definitions explicitly exclude exempt income and NANE income from being

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75 Ibid 434.

76 (1965) 112 CLR 386.

77 Ibid 397-8.

78 *Income Tax Assessment Act 1997* (Cth) s 8-1(2)(c).

79 *Income Tax Assessment Act 1997* ss 6-20 and 6-23.

assessable income.[80] It is impossible for expenditure or losses to be incurred in gaining exempt income or NANE income whilst also gaining assessable income. Therefore it is impossible for such expenditure ever to satisfy s 8-1(1) let alone fall foul of s 8-1(2)(c). Therefore, the exclusion adds nothing to s 8-1 and is effectively inoperative.. Accordingly, there is no additional work that s 8-1(2)(c) adds to s 8-1. A similar conclusion was reached in *Ronpibon Tin* where the Court considered similar provisions in the ITAA36.[81]

As a general rule, an effectively inoperative exclusion, such as s 8-1(2)(c), arises where the exclusion purports to exclude losses or outgoings where it operates by reference to concepts that are incompatible with s 8-1(1). Alternatively such exclusions can also arise where the exclusion looks to establish the connection of expenditure with income production with the expenditure. In these latter cases the failure to meaningfully exclude expenditure arises because the application of the exclusion follows the conclusion reached regarding s 8-1(1).

JUDICIAL CONSIDERATION OF SECTION 8-1(2)(B)

Decisions of the High Court show a tension whereby the Court has, over a number of decisions, suggested that s 8-1(2)(b) is effectively inoperative whilst at other times suggesting that it is a non-absolute exclusion capable of denying a deduction for losses or outgoings that otherwise satisfy s 8-1(1).[82] However, decisions in lower courts do not evidence this same view. Emanating from the Federal Court, four main cases exist that support the proposition that s 8-1(2)(b) is a non-excluding exclusion and is subsumed by s 8-1(1). Further Tribunal decisions provide examples of applications of the Federal Court approach to s 8-1(2)(b).

Murphy J noted that when read as a whole the general deduction provision is such that s 8-1(2)(b) was effectively inoperative as:[83]

> The exception in [section 8-1(2)(b)] of outgoings "to the extent to which they are losses or outgoings of… a… private or domestic nature" appears to be inserted in [section 8-1] as a matter of caution, it is difficult to see how "losses or outgoings to the extent to which they are incurred in gaining or producing assessable income" where those words first appear in [section 8-1(1)], could be losses or outgoings of a private or domestic nature.

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80 Ibid ss 6-15(2), (3).

81 (1949) 78 CLR 1, 56.

82 Compare the reasoning of Menzies J in *FCT v Hatchett* (1971) 125 CLR 494 and Murphy J in *FCT v Janmor Nominees Pty Ltd* (1986) 17 ATR 1007 with *John v FCT* (1986) 166 CLR 417, *Handley v FCT* (1981) 148 CLR 182 and *FCT v Forsyth* (1981) 148 CLR 203.

83 *FCT v Janmor Nominees Pty Ltd* (1986) 17 ATR 1007, 1014.

> To the extent to which they were of a private or domestic nature, they would to that extent not fall within the initial description of losses or outgoings incurred in gaining or producing the assessable income. It may perhaps be conceived that outgoings can have a dual characterization, but it is clear that, if that be so, the allowable deduction is to be limited to such extent of the outgoing as is not of a private or domestic nature.

Murphy J's is similar to that exhibited by Parsons; who developed this idea further when he noted that:[84]

> An excluding function for the private or domestic exception would require the adoption of a view that expenses that are private or domestic are to be denied deduction, however relevant to the derivation of assessable income they may be. This would in turn require the defining of private or domestic expenses in terms that do not let in considerations of relevance to the derivation of income.

Parsons recognised that expenditure on food, clothing and shelter "… would be prime candidates for categorizing as matters that are absolutely private or domestic – absolutely in the sense that they are such whatever their relevance to income derivation".[85]However, this approach would be unduly restrictive regarding outlying cases of expenditure such as where a baker purchases flour for use in the production of bread. The decision of *Cailebotte v Quinn*,[86] further illustrates the failings of categorising s 8-1(2)(b) as an absolute exclusion. The taxpayer claimed a deduction for lunches consumed on construction sites on the basis that:[87]

> ….his main reason for consuming lunch on working days was to sustain him in his work, and, in the winter, to keep warm. He did not regard lunch as a personal habit and only partly agreed that it was a basic requirement of a human being to eat and drink in order to stay fit and healthy… When at home he never took mid-morning or mid-afternoon refreshments.

Templeman J was required to consider whether the expenditure was deductible under the *Income and Corporate Tax Act 1970* (UK).[88] However, Templeman J's analysis is also applicable to considering how the nature of a loss or outgoing may be characterised as private or domestic. Templeman J held that:[89]

> …no part of the cost of the taxpayer's lunch was 'exclusively… expended for the purposes of' his trade as a carpenter. The cost of tea consumed by an actor at the Mad Hatter's Tea Party is different, for in that case the quenching of a thirst is

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84 Parsons, above n 38, 453.

85 Ibid.

86 [1975] 2 All ER 412.

87 Ibid 413.

88 The *Income and Corporate Tax Act 1970* (UK) s 130 provided for an exclusion of deductibility in an identical manner as was contained in the *Income Tax Assessment Act 1922.*

89 [1975] 2 All ER 412, 416.

> incidental to the playing of the part. The cost of protective clothing worn in the course of carrying on a trade will be deductible, because warmth and decency are incidental to the protection necessary to the carrying on of the trade. There is no such connection between eating and carpentry.

Templeman J's holdings suggest that losses or outgoings can have multiple characterisations depending upon the subjective facts surrounding the taxpayer. Parsons seized upon this and noted that if s 8-1(2)(b) operated as an absolute exclusion then "…it follows that the cost of the business lunch, the cost to the actor of refreshments taken in actual performance of the Mad Hatter's tea party… are not deductible."[90] Accordingly it is highly unlikely that s 8-1(2)(b) could be characterised as an absolute exclusion.

One position adopted by the High Court was that private or domestic losses or outgoings would almost never satisfy s 8-1(1); that is s 8-1(2)(b) was effectively inoperative. Menzies J stated this position in *FCT v Hatchett*[91] where the Court considered the deductibility of university fees by a teacher for undergraduate studies and also fees for a higher education certificate. In considering the character of the two outgoings, Menzies J concluded that:[92]

> It must be a rare case where an outgoing incurred in gaining assessable income is also an outgoing of a private nature. In most cases the categories would seem to be exclusive. So, for instance, the payment of medical expenses is of a private nature and is not incurred in gaining assessable income, notwithstanding that sickness would prevent the earning of income.

However, following *Hatchett*, the High Court in *John v FCT*[93] rejected Menzies J's reasoning where Mason CJ and Wilson, Toohey and Gaudron JJ held that they "…do not see any necessary antipathy between a loss or outgoing of a private nature."[94] The effect of this position being that their Honours concluded that some losses or outgoings must, theoretically, be capable of satisfying s 8-1(1) yet be excluded by s 8-1(2)(b). It is unclear whether their honours considered that s 8-1(2)(b) in its theoretical application would apply absolutely to certain classes of expenditure or rather was sensitive to the circumstances of individual taxpayers.

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90 Parsons, above n 38, 414.

91 (1971) 125 CLR 494.

92 Ibid 498.

93 (1988) 166 CLR 417.

94 Ibid 431.

THE DEDUCTIBILITY OF HOME OFFICE EXPENDITURE

The position stated in *John* found further support in the High Court decisions of *Handley v FCT*[95] and *FCT v Forsyth*.[96] However, in both decisions Murphy J tentatively suggested an alternative interpretation such that s 8-1(2)(b) operated as a non-absolute exclusion. Both *Handley* and *Forsyth* considered deductions relating to home offices maintained by self-employed barristers who ordinarily conducted their respective practices from chambers located away from their homes. In both decisions, the taxpayers were denied deductions.

In *Forsyth*, Wilson J considered the nature of the taxpayer's home office arrangements holding that as the home office was itself an integral part of the house "It would seem intimately related, in a physical sense, to the life of the family."[97] Therefore "… it is not open on the facts of this case to find that the outgoings in question were incurred in gaining or producing the assessable income."[98] Wilson J considered that it was unnecessary to determine whether the home office was of a domestic character because the office's intimate connection with the house resulted in the losses or outgoings failing to satisfy s 8-1(1).[99] Murphy J held the outgoing was of a domestic character despite being incurred in gaining or producing assessable income. This was because the taxpayer's expenditure was ultimately directed to a family trust and was therefore ultimately directed at comforting the taxpayer's family.[100] Murphy J's analysis differed from Wilson J's as Murphy J looked beyond the occasion of the expenditure by considering its ultimate destination and purpose. Murphy J's reasoning is consistent with *Ure* given that the expenditure was referable to comforting the taxpayer and their family and, accordingly, was not for the purpose of gaining or producing assessable income.

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95 (1981) 148 CLR 182.

96 (1981) 148 CLR 203.

97 Ibid 215.

98 Ibid.

99 Wilson J did continue in obiter and reconciled the Menzies J's reasoning in *FCT v Hatchett* by stating that domesticity can be a basis for excluding a deduction where expenditure is referable to a home, house or household; (1981) 148 CLR 203, 216. However compare that position with the Commissioner's concession that, in limited circumstances, a taxpayer may claim a deduction in respect of occupancy expenses for the use or ownership of a home; Australian Taxation Office, *Income Tax: Deductions for home office expense*, TR 93/30, 6 April 2011, [15]. The Commissioner's position appears inconsistent with Wilson J's reasoning that expenses related to a home, house or household are, by that fact alone, denied deductibility by s 8-1(2)(b).

100 (1981) 148 CLR 203, 207.

However, in *Handley*, Murphy J more forcefully suggested that s 8-1(2)(b) imposed a further test that looked to whether the expenditure irrespective of its relation to income production may contain a domestic character, noting that:[101]

> The taxpayer, like most other income earners with a family, had to spend most of the week days away from home engaged in his earning activities. He therefore wished to spend his evening and week-ends amid his family in circumstances where he could work if he wished… Any outgoing incurred for this purpose was of a domestic nature even if it were incurred in earning assessable income.

Murphy J suggests that one needs to look beyond the loss or outgoing itself and examine its subjective purpose in the hands of the taxpayer. Where the taxpayer's purpose is domestic such as by providing for a better quality of life, the entire loss or outgoing would be denied deductibility no matter how strongly it was incurred in gaining or producing the taxpayer's assessable income.

In *Handley*, Stephen J, dissenting, provided obiter relating to s 8-1(2)(b) noting that the exclusion of private or domestic expenditure was of little use because the phrase "to the extent that" in s 8-1(2)(b) provides for apportionment. Stephen J suggested that expenditure can be apportioned into two segments; an income producing segment satisfying s 8-1(1) and a private segment offending s 8-1(2)(b). Once a portion of expenditure fell within the first segment it could never exist within the second,[102] therefore, s 8-1(2)(b) did not apply to the portion satisfying s 8-1(1). In that regard, Stephen J expanded upon *Hatchett*; however, Stephen J could not contemplate an expenditure satisfying s 8-1(1) that also offended s 8-1(2)(b) as being entirely non-deductible. Ultimately, the issue for Stephen J then was whether expenditure was capable of apportionment.

Wilson J held that the home study expenditure was not deductible as it failed to satisfy s 8-1(1).[103] Wilson J's reasoning was that the home office was integral to the house and that expenditure regarding the home office such as a portion of interest and utilities was not capable of apportionment as it related to the home as a whole.[104] Mason J concurred with Wilson J although provided for a more explicit subsuming of s 8-1(2)(b). Mason J held:[105]

> … the study is a room in the taxpayer's home, not separate from it in any way…. When used for professional work it is ordinarily used only for professional work

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101 (1981) 148 CLR 182, 196.

102 Ibid 191.

103 Ibid 202.

104 Ibid 201-2.

105 Ibid 194.

> that can be done at home… Expenditure related to the study is therefore referable to the home.

Mason J continued holding that the appropriate test to determine the expenditure's domestic character is that of the 'essential character' of the expenditure as stated in *Lunney*.[106] The subsuming is obvious as the test imposed by *Lunney* is duplicated; it would be hard to imagine, as noted in *Hatchett*, circumstances where a loss or outgoing had both the essential character of being incurred in gaining or producing assessable income whilst also possessing an essential character as being private or domestic expenditure.

THE FEDERAL COURT AND AAT'S CONSIDERATION OF EXPENDITURE ON FOOD AND CLOTHING

The Federal Court has considered the deductibility of expenditure regarding items ordinarily considered private or domestic on a number of occasions. *Cooper, Edwards*, *Mansfield*[107] and *Morris*[108] are examples where the Court has considered outgoings on conventional clothing and food.

THE DEDUCTIBILITY OF EXPENDITURE REGARDING FOOD

Cooper concerned the deductibility of additional food consumed by a professional rugby league player. The taxpayer's objective in eating the additional food was to ensure that they were of sufficient bulk to continue playing professional rugby league. In the Full Federal Court appeal, the taxpayer was denied a deduction for the cost of that food. In denying the deduction, the Court did not rely on s 8-1(2)(b), rather the Court relied on s 8-1(1). Lockhart J held (Hill J concurring)[109] that in all cases the facts dictate the outcome as:[110]

> The deductibility of expenditure on food, clothing and housing poses difficult questions. In one sense expenditure on food is always relevant to the derivation of income because a person must eat to enable him to live and therefore to work. Obviously that alone is not a sufficient connection… on the other hand a person whose business is the publication of a food guide may buy and taste foods in the course of his business, so there is a clear nexus between the expenditure and the derivation of income. The cases that lie in between the two extremities give rise to the difficulty…

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106 Ibid 194.

107 (1995) 31 ATR 367.

108 (2002) 50 ATR 104.

109 (1991) 29 FCR 177, 199-200.

110 Ibid 184.

Similarly, Hill J held that:[111]

> Food and drink are ordinarily private matters, and the essential character of expenditure on food and drink will ordinarily be private rather than having the character of a working or business expense. However, the occasion of the outgoing may operate to give to expenditure on food and drink the essential character of a working expense in cases such as those illustrated of work related entertainment or expenditure incurred while away from home.

Their Honours indicated that the nature of an object acquired by expenditure does not determine the deductibility of the expenditure. Lockhart J's example suggests that a food critic should be entitled to a deduction for the cost of food acquired to criticise in the course of the critic's business. Second, it appears that the 'essential character' test of s 8-1(1) is the determinative test when considering the deductibility of a loss or outgoing and that there is a threshold question of the requisite nexus to satisfy that test. The mere fact that the outgoing is necessary does not render it sufficient and accordingly deductible.

Similar to *Cooper*, *Case J3*[112] highlights the factual sensitivities of decisions. *Case J3* considered a professional footballer's deduction for fees to play squash. The taxpayer played squash to condition himself to maximise their football playing potential.[113] The Board allowed the taxpayer a deduction, Chairman Hogan found no need to consider s 8-1(2)(b) being satisfied that once it was accepted that playing of squash was to condition the taxpayer so that they could play football it was "…part and parcel of the taxpayer's employment."[114] Member Dempsey also omitted analysis regarding whether the expenditure was of a private nature, preferring only to consider whether there was a connection between the taxpayer's income producing activities and the expenditure.[115] In contrast, Member Gerber did consider s 8-1(2)(b) and the Commissioner's submission that as the taxpayer obtained some enjoyment from playing squash that enjoyment coloured the expenditure as being private in nature. Member Gerber rejected that submission noting that it was not soundly based on law as it was not necessary for taxpayers not to enjoy in any capacity the fruits of their expenditure in obtaining a deduction.[116]

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111 Ibid 201.

112 (1977) 77 ATC 39.

113 Ibid 40.

114 Ibid.

115 Ibid 43.

116 Ibid 43-4.

THE DEDUCTIBILITY OF EXPENDITURE ON CLOTHING

The Full Federal Court in *Edwards* adopted a similar approach to that in *Cooper*. On appeal to the Federal Court from the AAT,[117] Gummow J considered whether outgoings on ordinary clothing worn by a personal secretary were deductible. Gummow J relied on *Cooper* in holding that the requirements of the taxpayer's employment are relevant in determining the essential character of an outgoing.[118] Gummow J held that a condition of the taxpayer's employment was that they dress in a manner similar to their employer despite no such formal or express condition in the taxpayer's employment contract.[119] Gummow J emphasised the importance of establishing that expenditure to acquire the clothing had the requisite essential character. From there, Gummow J noted that a secondary test such as whether the outgoing was on clothing that was necessary or peculiar would "…tend to obscure the application of [section 8-1.] That, of course throws one back to the search, among other things, for the essential character of the outgoing."[120] In finding for the taxpayer, Gummow J affirmed the AAT's reasoning that:[121]

> There is nothing about the additional changes 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 AAT's reasons at first instance conflated sections 8-1(1) and 8-1(2)(b). The AAT was satisfied that once the clothes were determined to be relevant to the taxpayer's income production they ceased to have the character of expenditure on clothing; that is 'domestic' expenditure. Gummow J similarly conflated the s 8-1(1) and 8-1(2)(b) holding that:[122]

> …there was a direct nexus between the allowable outgoing and the taxpayer's income producing activity. Further, the AAT did not err in law in holding that the essential character of the outgoing was not to clothe herself… but to enable her to perform satisfactorily the duties of her position. It was implicit in the AAT's reasoning that the otherwise allowable expense was not of a private or domestic nature.

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117 *AAT Case 8858* (1993) 26 ATR 1181.

118 (1993) 27 ATR 239, 295.

119 Ibid.

120 Ibid 299.

121 *AAT Case 8858* (1991) 26 ATR 1181, 1185.

122 (1993) 27 ATR 1181, 1185.

In *AAT Case 8658,*[123] decided at the time of *Edwards*, the AAT held that expenditure regarding clothing outlaid by a fashion editor who spent a disproportionately large amount of money on fashionable clothing ($10,917 in one year of income) was not deductible. The AAT accepted that the taxpayer was required to dress appropriately for the occasion she was attending; for example at a fashion parade she was required to dress in a forward fashioned outfit so as to promote her employer's image of cutting edge fashion.[124] However, the AAT denied a deduction for the cost of clothing because "…unlike a model, the applicant was not paid to wear clothes…"[125] The AAT's reasoning appears to be based on Lockhart J's holdings in *Cooper* that "The taxpayer was paid money to train for and play football, not to consume food and drink."[126] Regardless it was apparent from the AAT reasons that the AAT was unwilling to grapple with s 8-1(2)(b) and rather preferred to adopt a very narrow construct of the taxpayer's income producing activities so as to deny a deduction on the basis of failing to fulfil s 8-1(1). With respect, this decision is hard to reconcile with *Edwards.*

In the more recent AAT decision of *Re Taxpayer and FCT,*[127] the AAT considered whether a presenter required to wear different clothes to present particular images could deduct the outgoings on those clothes. The taxpayer maintained an 'A list' of high quality clothing that was used solely for seminars.[128] As in *AAT Case 8658*, Member Swieden applied a narrow construction of the taxpayer's income producing activities stating that:[129]

> While the A list clothes assisted in creating an image compatible with the applicant's perceptions of her clients' and audiences' expectations, her activities productive of income did not turn upon her wearing A list clothes, however important the applicant may have perceived these clothes to be in her presentation activities.

Similarly in *AAT Case 12194,*[130] the AAT refused a deduction for the cost of acquiring black trousers for a waiter required to wear those trousers for work. The case paralleled *Edwards* in many respects as the taxpayer was required to wear the trousers at work, did not wear the trousers outside of work and the trousers were of

123 (1993) 25 ATR 1115.
124 Ibid 1117.
125 Ibid 1119.
126 (1991) 29 FCR 177, 185.
127 (2006) 61 ATR 1192.
128 Ibid 1202.
129 Ibid 1203.
130 (1997) 37 ATR 1017.

an ordinary kind.[131] In denying the taxpayer a deduction, the AAT held that the facts:[132]

> …fail to establish a sufficient connection between the purchase of the black trousers and the income earning activity to allow the purchase of the black trousers to be tax deductible.
>
> Mr Westcott [the taxpayer] would wear trousers, of some colour, at work even if not required to wear black trousers.

AAT Case 12194 in particular illustrates the problem of relying too heavily on s 8-1(1) to deny deductions for domestic items. The decision must be wrong given that it ignores *Edwards*, to say that the taxpayer was always going to wear trousers is an irrelevant consideration. In *Edwards*, the taxpayer was always going to attend work in a state of dress even if not required to attend work in appropriate clothing, however this was no impediment to obtaining a deduction. Similarly, such considerations must be wrong as it would lead to decisions contrary to well established principles such as the deductibility of expenditure regarding protective clothing.

The AAT moved away from the decision of *AAT Case 12194* in *Re Staker and FCT*.[133] *Staker* considered, like *Edwards*, a taxpayer who required multiple changes of clothes a day in their occupation as a fitness instructor. The changes of clothes enabled the taxpayer to instruct different classes and maintain an image suited to their employer's image. However, a deduction was denied based on s 8-1(2)(b) where Deputy President Hack held that[134]:

> …except for the occasions when [the taxpayer] was wearing the gym uniform supplied by her employer, her daily clothing was not in the nature of a uniform which otherwise had no use to her. There was not about it any feature that took it beyond the provision of "modesty, decency and warmth" albeit on some occasions in differing settings and, on other occasions, in different settings on the same day.

Whilst the clothing was worn in the course of work it was the fact that the clothing also served a domestic purpose; providing warmth and decency, that prevented a deduction being allowed.[135] This approach is similar to Murphy J's reasoning in *Handley* and *Forsyth*.

The Federal Court further considered the deductibility of clothing expenditure in *Mansfield* and *Morris*. In both decisions deductions were allowed regarding

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131 Ibid 1019-20.

132 Ibid 1020.

133 (2007) 66 ATR 895.

134 Ibid 901.

135 Ibid.

expenditure relating to purchases of; hosiery, shoes and makeup (*Mansfield*) and, sunscreen and sunglasses (*Morris*).

In *Mansfield*, Hill J considered the deductibility of outgoings on hosiery, shoes, hydrating and ordinary makeup, and hairdressing for an air hostess. The taxpayer claimed that it was a requirement of her employment that she be well groomed and presented well and hence the expenditure was deductible.[136] Hill J allowed a deduction regarding hydrating makeup as such expenditure could be connected to the taxpayer's employment conditions given the harsh working environment of an aeroplane's cabin causing dehydration.[137] However, regarding ordinary makeup, Hill J, in obiter, indicated that s 8-1(2)(b) may contribute to s 8-1 by excluding certain expenditure on the basis that it is *ipso facto* private or domestic in nature when he stated that "I am presently of the view that makeup retains an essential personal characteristic which excludes it from deductibility."[138] In contrast when considering the expenditure on shoes, Hill J discarded the above proposition and seized upon the fact that the shoes were required to be a half size larger than the taxpayer wore off-duty due to swelling experienced in an aeroplane's cabin, holding that:[139]

> It is these features that lead, in my view, to the conclusion that the occasion of the outgoing on shoes, that is to say cabin shoes, should be seen as being found in the duties which Mrs Mansfield performed as a flight attendant…"

Rather than consider the subjective character of the goods acquired by the taxpayer in their hands the ATO stated that the cost of shoes was not deductible,[140] relying on *Case 95.*[141] *Case 95* proposed a three element test as to whether outgoings related to clothing were deductible comprising: first, the purpose of the clothing, secondly, the distinctiveness of the clothing, and thirdly, the ability for the clothing to be worn outside the work environment.[142] However, *Case 95* is an example of a subsuming of s 8-1(2)(b) in to 8-1(1) as the AAT framed the ultimate issue as not whether those three elements suggested that the clothing outlay was of a private or domestic nature but rather whether a sufficient nexus existed between the outgoing and the taxpayer's income producing activities.[143]

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136 (1995) 31 ATR 367, 368.
137 Ibid 374.
138 Ibid 374.
139 Ibid 375.
140 Taxation Ruling TR 93/D10. [30].
141 (1987) 87 ATC 575.
142 Ibid [17].
143 Ibid [21].

In considering the hosiery outgoings, Hill J conflated s 8-1(1) and 8-1(2)(b). Hill J was satisfied that the expenditure had the essential character of being incurred in gaining or producing assessable income because of:[144]

> …the fact that the pantyhose is part of the uniform which Mrs Mansfield is required to wear… it finds a differentiation from ordinary clothing, so that the necessary relationship is to be found between the expenditure on the pantyhose and Mrs Mansfield's occupation as a flight attendant and likewise the essential character of the expenditure is not to be seen as private.

This position ought to be contrasted with that of the taxpayer's claim for hairdressing where the fact that the taxpayer had a choice in styles was considered to result in the outgoing being of a domestic nature. This distinction seems to provide a mid-point between the treatment of hosiery and shoes and other objects. Whilst Hill J looked to the necessity of the hosiery and shoes in relation to their inability to be used outside the cabin environment it appears that where capacity exists for an object to be utilised outside of the taxpayer's income producing activities that may affect claims of deductibility. In that regard the approach is somewhat similar to Murphy J's non-absolute exclusion construction outlined in *Handley* and *Forsyth*.

THE DEDUCTIBILITY OF SUNSCREEN, SUNGLASS AND OTHER PRODUCTS

In *Morris*, Golberg J considered the deductibility of expenditure on sunscreen, sunglasses and other products by taxpayers employed variously as: builders, carpenters, farmers, ATO auditors and tennis umpires. The taxpayers claimed that by working outside sunscreen and the other products were analogous to protective clothing and improved their working efficiency. Therefore, expenditure on such products had the essential character of being incurred in gaining or producing assessable income. The Commissioner contended that the taxpayers were not employed to wear sun products, therefore, the outgoings did not satisfy s 8-1(1). Alternatively, the products provided comfort and thus did not satisfy s 8-1(2)(b).

In finding for the taxpayers, Goldberg J did not consider s 8-1(2)(b) independently of s 8-1(1) as s 8-1(2)(b) "…requires an assessment of the connection between the expenditure and the income-producing activity of the taxpayer in order to determine whether the expenditure is, or is not, of a private nature."[145] In effect, once the expenditure satisfied s 8-1(1) in that it was incurred for income producing purposes, then that consideration determines whether the expenditure was of a private nature. Goldberg J's construction of s 8-1(2)(b) placed it firmly in the category of an effectively inoperative exclusion.

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144 (1995) 31 ATR 367, 376.

145 (2002) 50 ATR 104, 128.

ATO INTERPRETATION OF SECTION 8-1(2)(B)

The ATO's construction of s 8-1(2)(b) appears reactive and varied as the law develops.[146] However, the history of the ATO's construct indicates that it prefers an objective view of s 8-1(2)(b), that is, unlike Parsons and the overwhelming majority of case law considered above, the ATO considers that s 8-1(2)(b) may operate to exclude absolutely some expenditure. For example the ATO considers in relation to expenditure regarding 'tails' for orchestra members that:[147]

> Tails which may on occasion be worn by conductors and other members of orchestras are also considered to be conventional clothing. We consider that tails are simply a style of evening dress, and not unique to orchestral performance. Accordingly, their cost is not deductible.

Regarding meals taken between the completion of employment with an employer where the taxpayer worked for multiple employers, the ATO characterises meals per se as being private or domestic in nature as:[148]

> In *FC of T v Cooper*… the majority of the Full Federal Court held that the essential character of food and drink will ordinarily be private rather than being related to the earning of income. We accept this judgment as having general application.

In these cases, the ATO focuses on the nature of items for which an outgoing relates rather than the connection of that outgoing with a taxpayer's income producing activities. In doing so, the question of whether the cost of the tails or meals was incurred in the course of gaining or producing income and has the essential character of being incurred in the course of gaining or producing income is irrelevant because the tails and food themselves have the essential character of a domestic expense.

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146 For example, compare the ATO's position regarding deductibility of 'conventional clothing' as worn by police officers in TD 93/110W (Australian Taxation Office, *Income tax: is a police officer who is required to wear conventional clothing e.g., suits, shirts, ties, jeans and shoes entitled to a deduction for the cost of purchasing, cleaning and maintaining such items?*, TD 93/110W, 17 June 1993) where the ATO held that such expenditure was not deductible whilst in TR 94/22 (Australian Taxation Office, *Income tax: implications of the Edwards case for the deductibility of expenditure on conventional clothing by employees*, TD 94/22, 28 July 1999) the ATO reversed that position by determining that such expenditure was deductible. The ruling continued by providing, at paragraph 28, an example directed at such expenditure incurred by police officers.

147 Australian Taxation Office, *Income tax: is expenditure on dinner suits and other similar clothing worn by members of an orchestra deductible?*, TD 93/111, 17 June 1993, [3].

148 Australian Taxation Office, *Income tax: is the cost of a meal purchased after the completion of one job and prior to the commencement of another job an allowable deduction?* TD 93/26, 18 February 1993, [2].

Further, the ATO oversimplifies the decision in *Cooper*, it is difficult to rely on *Cooper* to conclude that certain outgoings to acquire items such as tails or food is inherently private or domestic. Lockhart J explicitly recognised that it was impossible to do this where he recognised the example of purchases of food by a food critic. In Lockhart J's analysis the question returns to whether s 8-1(1) can be satisfied and not whether s 8-1(2)(b) otherwise denies a deduction. On the other hand the ATO may be placing reliance on Hill J in *Cooper* who suggested that as a matter of practicality most instances of outgoings on items such as food will not possess the requisite essential character required by s 8-1(1).

Finally, the ATO's position regarding the interactions of s 8-1(2)(b) and s 8-1(1) lead to unnecessary complexities in administration. A result of this approach has been the need for the ATO to publish numerous rulings itemising 'allowable' deductions for particular occupations.[149]

RESOLVING THE PROBLEM OF SECTION 8-1(2)(B)

The cases analysed above indicate the difficulty in applying s 8-1(2)(b). Further, the problem identified is not abstract given the High Court's most recent decisions concerning s 8-1. In *FCT v Citylink Melbourne Ltd*,[150] the judgments of Crennan J (Gleeson CJ, Gummow, Callinan and Heydon JJ concurring) and Kirby J suggest a return to a rigorous consideration and application of basic taxation principles. Whilst this decision regarded s 8-1(2)(a), Crennan J's methodology indicated a thorough approach to resolving questions of deductibility and heavy reliance on *Sun Newspapers*.[151] Further, the methodology is evident in *Anstis* where a three stage approach to s 8-1 cases was adopted that considered in turn; the assessability of the income to which the deduction relates, the satisfaction of s 8-1(1) and finally the application of any s 8-1(2) exclusions.[152]

The cases analysed above indicate two approaches exist regarding the role of s 8-1(2)(b); either it adds nothing to s 8-1(1) and is effectively inoperative, or, by various means s 8-1(2)(b) limits the field of deductible losses or outgoings that satisfy s 8-1(1) and is thus an absolute or non-absolute exclusion. The majority of decisions reflect the first view that s 8-1(2)(b) is effectively inoperative. However, judgments such as Murphy J's in *Forsyth* and cases looking beyond the income producing nexus of losses or outgoings such as in *Re Staker* support the alternative view of an absolute or non-absolute deduction.

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149 These rulings begin at Taxation Ruling TR 95/8 through to Taxation Ruling TR 95/22 and considered allowable deductions for employees in various fields of employment.

150 (2006) 228 CLR 1.

151 Ibid 43-4 (Crennan J), 12-5 (Kirby J).

152 *FCT v Anstis* (2010) 241 CLR 443, 448.

The first approach purports that s 8-1(2)(b) is effectively inoperative. For example, in *Edwards* the Court's holding that the additional clothing's income producing purpose prevented the expenditure being private or domestic supposed that s 8-1(2)(b) added nothing to s 8-1. Alternatively, the Court indicated that s 8-1(2)(b) considered whether expenditure had the character of being incurred in gaining or producing assessable income. A result of this later view is that s 8-1(2)(b) replicates s 8-1(1) and is thus effectively inoperative.

The problem with the approach exemplified by *Edwards* is that it requires s 8-1(2)(b) to be constructed such that its words have no purpose. Doing so opposes well established authorities such as *Commonwealth v Baume*[153] and *Cooper Brookes (Wollongong) Pty Ltd v FCT*[154] that indicate that all words in a statute are read according to their plain and ordinary meaning and are not immaterial.

Baume provides an imperative that wherever possible words must be given meaning. In establishing the imperative, Griffith CJ relied on *The King v Brechett*[155] for authority for to conclude that:[156]

> … in the interpretation of statutes that such a sense is to be made upon the whole as that no clause, sentence or word shall prove superfluous, void or insignificant, if by any other construction they may all be made useful and pertinent.

O'Connor J stated the same proposition more forcefully:[157]

> To adopt the plaintiff's contention in this case would be to treat the words… as if they were omitted from the section. According to every recognized rule of construction we must give a meaning to them.

Whilst aging, the line of authority established by *Brechett* is expansive showing consistent application of the principle. In *Beckwith v The Queen*[158] the High Court considered whether a general provision in the *Customs Act 1901* stating that it was an offence to attempt an offence under s 233B of that Act; s 233B itself provided that the attempted attempt[159] at importation of narcotics was an offence.[160] Gibbs J, with

153 (1905) 2 CLR 405, 415.

154 (1981) 147 CLR 297, 304-5.

155 [1688] 1 Show KN 106.

156 (1905) 2 CLR 405, 414.

157 Ibid.

158 (1976) 135 CLR 569.

159 Ibid 570, Gibbs J reproduced part of the indictment which stated that Respondent "… did attempt to commit an offence against the said Act in that he attempted to have in his possession without reasonable excuse prohibited imports to which Section 233B of the said Act applied…"

160 Ibid 572-3.

Stephen J concurring,[161] noted that "As a general rule a court will adopt that construction of a statute which will give some effect to all of the words which it contains."[162] Both *Chu Kheng Lim v Minister for Immigration*[163] and *Project Blue Sky Inc v Australian Broadcasting* Authority[164] also support the principle. *Project Blue Sky Inc* indicated that the principle is an entrenched in the judiciary's approach to statutory interpretation with McHugh, Gummow, Kirby and Hayne JJ held that "… a court construing a statutory provision must strive to give meaning to every word of the provision."[165]

However, in *Chu Kheng Lim*, Mason CJ noted that the rule must be balanced against other concerns; particularly he noted that a superfluous interpretation is preferable to one that is retrospective or limiting upon liberty.[166] Ultimately when determining whether to apply the superfluous interpretation there is a need to have a well founded basis for doing so.[167]

The second rule of construction as stated in *Cooper Brookes* is that when construing a statute the legislature's intent must be given effect.[168] But, when giving effect to that intent it "…is not unduly pedantic to begin with the assumption that words mean what they say…"[169] such that "If, when the section in question is read as part of the whole instrument, its meaning is clear and unambiguous, generally speaking 'nothing remains but to give effect to the unqualified words'".[170] This principle remains in place and was most recently cited by the High Court in *Stingel v Clark* by Gummow J.[171] It is unlikely that a superfluous interpretation of s 8-1(2)(b) is correct particularly given that it could be read using the 'ordinary' meaning of the words 'private and 'domestic'.

The second approach is seen in Murphy J's judgments in *Handley* and *Forsyth* and Member Gerber's reasoning in *Case J3*. That is, s 8-1(2)(b) works as either an absolute or non-absolute exclusion. This approach avoids the interpretation problems faced by a superfluous interpretation but is subject to unique faults.

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161 Ibid 578.

162 Ibid 574.

163 (1992) 176 CLR 1.

164 (1998) 194 CLR 355.

165 Ibid 382.

166 (1992) 176 CLR 1, 13.

167 *Hill v William (Park Lane)* [1949] AC 530, 546-7.

168 (1981) 147 CLR 297, 304.

169 Ibid.

170 Ibid.

171 (2006) 226 CLR 442, 468. See also *Stevens v Kabushiki Kaisha Sony* (2005) 224 CLR 193 where the Court indicated a preference in adopting the ordinary meaning of words used in an Act.

First, the categorisation of s 8-1(2)(b) as an absolute exclusion ought to be rejected. In *Anstis*, French CJ, Gummow, Keifel and Bell JJ stated that "...the concept of a particular type of expenditure being absolutely or always 'private' cannot be sustained."[172] The second problem concerns the word 'private' itself; the ordinary sense of the word would be a reference to outgoings and losses that related to items or services purchased by and for the benefit of the taxpayer personally.[173] But adopting this interpretation gives a superfluous outcome as the essential character test in s 8-1(1) already asks where a loss or outgoing is incurred for a non-income producing (private) purpose. This problem does not exist regarding the ordinary meaning of 'domestic'[174] it is conceivable then that using such meaning could exclude expenditure regarding things as; kitchen knives, flour, domestic flooring and similar items. However, such interpretation may lead to inequitable treatment of some taxpayers such as chefs or bakers as compared to others. Further, 'domestic' could not be interpreted subjectively to avoid this as doing so would have the safe outcome of applying the ordinary meaning of the word 'private'.

Section 8-1(2)(b) possesses a problem because it is impossible to provide a construction that either operates to exclude certain expenditure or a construction that operates equitably. This suggests that s 8-1(2)(b) should be omitted from the ITAA97 so long as the test of essential character under s 8-1(1) is maintained. However, if the courts were to move towards *Ronpibon Tin*'s test of 'relevant and incidental' then there could be a need to limit that broad concept by reference to private or domestic expenditure.

A possible resolution can be implemented by removing s 8-1(2)(b) whilst strengthening s 8-1(1) using by replacing 'incurred' with 'substantially incurred' to limit the field of deductible losses or outgoings. This approach would achieve two things. First, if the 'relevant and incidental' test of *Ronpibon Tin* were to re-emerge, the word 'substantially' would limit that otherwise very broad concept. Second, 'substantially' would add dimension to the essential character test and provide an ability to deal appropriately with expenditure that is not overtly relevant to income production or falls within questionable categories of losses or outgoings. Third, whether a loss or outgoing is incurred in gaining or producing assessable income is already a question of degree; some outgoings obviously appear more connected to the taxpayer's income production whilst others are less so. Accordingly, adding the word 'substantially' is in some way a formalisation of the existing effect of s 8-1(1) and acts to recognise the actual threshold that the section places on deduction claims.

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172 *FCT v Anstis*(2010) 241 CLR443, 459.

173 Catherine Soannes (ed.), *Concise Oxford English Dictionary 12th Edition*, (Oxford University, 2008).

174 Ibid.

The use of words such as 'substantially' denoting a requisite degree of connection in statutes is not uncommon nor something to be avoided. For example the *Bail Act 1977* (Vic) uses the words 'unacceptable' to qualify the requisite degree of risk necessary before an accused may be denied bail.[175] Other examples include the definition of 'character concern' under the *Migration Act 1958* (Cth) which deems a person to be of character concern if they are a 'significant' risk with regard to certain matters.[176] Similarly, under Division 83A of the ITAA97 an employee's interest in an employee share scheme must either be at a 'real risk' of forfeiture or have 'genuine' restrictions placed upon disposal of the interest to obtain deferred taxation treatment.[177] These examples show how qualifying words can be used to limit the scope of otherwise broad provisions by increasing the necessary threshold required to engage the substance of a provision and the adaptability of this approach to a broad range of matters.

CONCLUSION

The application of s 8-1(2)(b) is difficult to identify. Within the core concepts of s 8-1 that consider the connection of expenditure with income production and apportionment it is unclear what purpose s 8-1(2)(b) serves. This is evident from the cases analysed above which suggest that courts and tribunals tend to rely on s 8-1(1) to exclude deductions where one would expect s 8-1(2)(b) to be applicable. Further, applying s 8-1(2)(b) so as to exclude expenditure that otherwise satisfies s 8-1(1) poses difficulties of itself in that doing so may lead to inequitable results if courts were to deny deductibility regarding expenditure that, objectively, is considered private or domestic. Similarly, determining the domesticity of expenditure by reference to a taxpayer's subjective circumstances would, in effect, lead to a duplication of the essential character test set out in s 8-1(1). Therefore, it appears that s 8-1(2)(b) is effectively inoperative and accordingly could be removed from the ITAA97.

[175] *Bail Act 1977* (Vic) s 4(2)(d)(i).

[176] *Migration Act 1958* (Cth) s 5C(1)(d).

[177] *Income Tax Assessment Act 1997* (Cth) s 83A-115(4).