# REVISITING THE MAIN DEDUCTION PROVISION: CLEAR CONCEPTS FOR A MASS DECISION-MAKING TAX SYSTEM

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[*This article revisits the central deduction provision in s. 51. It concentrates on clarifying the core of the provision but also fits timing issues and capital-income issues into the integrated whole. The model sees s. 51 as a broad statutory directive which gives coherence to delegated rule making by judges and bureaucrats. It emphasizes hard practical dilemmas in giving operational shape to the deduction test in the context of mass decision-making realities. It addresses problems in reconciling characterization approaches with the statutory authority to apportion expenditures. It proposes guidelines to structure delegated decision-making.*]

## *Focusing on the Core of Section 51*

The main deduction provision in s. 51 is one of the most important in the Income Tax Assessment Act 1936. The core concept is unusually clear. It directs that an expenditure can be deducted only if it was spent to earn assessable income.

Section 51 is the sort of provision you would want in a new look Australian tax system driven by self-assessment and adapting to extensive modernization changes. Such a system would put a premium on clear communication and be capable of responding flexibly to policy imperatives. Section 51 lays down a clear, uncluttered core concept and delegates implementation and detailed rule making, within this coherent conceptual structure, to rule makers in the Tax Office and, ultimately, to the judges. The problem is that a systematic set of guidelines to structure the exercise of this delegated decision-making process is not laid down in the legislation and attempts by delegated decision-makers to develop a systematic approach to the provision are only now getting into their stride after the tax avoidance carnage of the 1970s.

In this article I want to keep the focus firmly on that core concept and to develop practical guidelines to give operational form to the core concept. Later parts of the paper contain a rundown on other important issues in the application of s. 51.

In recent years, much analysis of the core concept in s. 51 has drifted into rather sterile argument about the wording of various formulas proposed in older case law. We have lost the wood, what we are trying to do with deductions, in the undergrowth of a long list of specifics or measures targeted at various loopholes. Much analysis has simply confused the core issue with timing or capital/income questions. As we get back to the basic concept and the elaboration

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process evolves, it needs to be informed by day-to-day practical problems, it needs to develop within a coherent policy framework and it needs to pay attention to the comparative expertise of various parts of the decision making structure.

The language of s. 51 requires that expenditure be incurred in producing assessable income or, as we shall see later, incurred as part of the process of producing assessable income. It is the nature of that connection between the expenditure and the income producing process which is the 64 billion dollar question. In what sense must they be connected? Let us unravel the strands of this linkage.

— *Central Gateway Test*: This is the core issue. It concentrates on whether expenditure was spent to earn assessable income rather than some other reason, like personal enjoyment or to earn exempt income. This is the central gateway and control point over the deductibility of expenditures. For example, can a taxpayer deduct an *ex gratia* Christmas bonus paid to an employee for good work or lawyers' fees for the defence of employees in criminal proceedings connected with work or an artificially hiked expenditure made to a related service trust as part of a tax avoidance scheme?

— *Timing Nexus*: How closely, on a plane of time, must an expenditure be tied to the production of assessable income? How closely must it be tied to particular items of assessable income? Suppose cash is spent on general advertising to boost a firm's image or prestige and it cannot be tied closely to any particular income-earning sales, or to income coming in penny by penny in that particular year. Suppose expenditures are incurred in keeping up an office in the *hope* that future assessable income will be derived or spent before the income earning process starts. Are these expenditures deductible?

— *Capital-Income*: An expenditure which can be labelled 'capital' is not deductible under s. 51. It should be noticed that the test in the leading decision of *B.P. Australia Ltd v. Federal Commissioner of Taxation*,[1] which asks how closely an expenditure is tied to the sums coming back penny by penny from trading operations, overlaps substantially with the criteria used in the timing nexus test. But for their separate historical antecedents there might be a great deal to be said for integrating these two tests. Of course, after the introduction of the Capital Gains provisions, s. 51 does the entirely new job of demarcating expenditures deductible against assessable income from items which are deductible only as part of the capital gains cost base.

If the central gateway test is to be sensitive to the detailed practical problems which arise in its implementation, it is not helpful to develop guidelines at a very high level of generality. In the real world, untidy complexity and administrative constraints will inevitably intrude and they must inform our generalizations. The trick is to make sure that the complexity is managed within a coherent conceptual structure which, in turn, is sensitive to feedback about implementation problems. It is because the law was not sensitive to technical implementation problems, because legalistic dogma rather than pragmatic policy appreciation and practical feedback drove the law and because structural weaknesses were mobilized so

[1] (1965) 112 C.L.R. 386.

effectively by tax avoiders that the integrity of the tax base was so seriously compromised in the past. Many of the schemes were targeted at precisely the practical difficulties the judges had in unscrambling composite expenditures or dealing with discounted future cash flows. Consider the following continuing problems:

— What happens when a composite expenditure is spent earning assessable income but a scheme is constructed to cream off a percentage of the expenditure to split income (*e.g. Cecil Bros*[2] and *Phillips*[3] schemes)?
— What happens where an expenditure is, at one and the same time, for the personal benefit of the taxpayer and in pursuit of business purposes? *e.g.* the holiday in the Tasmanian wilderness for a geography teacher, the aerobics class for the footballer or lunch in a five star restaurant for the salesman entertaining a client.
— What happens where an expenditure is adequately connected with the earning of assessable income but exceeds assessable income and some other non-taxable, deferred or tax sheltered profit accrues to the taxpayer?
— Can an expenditure be deducted in 1990 dollars if it is incurred to generate the same face value of return in discounted 1995 or 2000 dollars?
— What happens if a payment is made to old employees or old directors to bolster inadequate superannuation or as a golden-handshake or a Christmas bonus to existing employees, a payment not strictly required by business obligations but arising from general business morality or normal human decency?

*Past Attempts to Formulate a Central Gateway Test*

With these problems in mind, let us return to the core concept and examine some earlier attempts to flesh it out. The main question, to use the statutory language, is whether expenditure was incurred to produce assessable income. In the vast majority of ordinary assessments this will be perfectly obvious. Expenditures for trading stock, wages to employees, rents for business premises, relevant trade journals are all spent to earn the relevant income. At the borderline, there is a long history of attempts to formulate a test. Much of this analysis is not helpful. It is not the formulas themselves which must be taken seriously but whether the formulas advance the clarity of analysis when we address practical issues. On this litmus, much of the older analysis is not very helpful. The following tests will be considered:

— *Early Formulas*: Was the expenditure 'incidental and relevant' to producing assessable income or 'both sufficient and necessary' to the production of assessable income?
— *Legalistic Test*: Was the legal effect (as opposed to its 'reality' or 'economic consequences') such that with the expenditure the taxpayer acquired a legally enforceable right to a benefit other than assessable income?

[2] (1964) 111 C.L.R. 430.
[3] (1978) 8 A.T.R. 786.

— *Purpose Test*: Was the purpose of the expenditure to produce assessable income or something else?
— *Essential Character Test*: Was the expenditure both an essential pre-requisite to the derivation of assessable income (*i.e.* causally related) and also of an income-earning character?

The formulas from the early authorities project a comforting aura of substance but they hardly advance the search for coherence and often divert our attention from the core requirements of the legislation itself. When all is said and done, it is the statute and not the judges' language which is the fundamental source of the law. Best known is the test from *Ronpibon Tin N.L. v. Federal Commissioner of Taxation*[4] which says that the expenditure must be 'incidental and relevant' to earning assessable income. This ambiguous formulation hardly helps to structure the core concept. The often-quoted formula of Dixon J. in *Amalgamated Zinc (de Bavay's) Ltd v. Federal Commissioner of Taxation* 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 operation . . . and the relevance thereto of the expenditure than to purpose in itself'[5] was merely an obscure way of saying that the formula referred to temporal issues rather than the central gateway problem. Dixon J., like Shakespeare, has assumed such divine status that even his less conspicuous statements receive disproportionate attention. Far more penetrating is Dixon J.'s detailed analysis in *Robert G. Nall v. Commissioner of Taxation*[6] but, lacking a pat phrase, it is cited less often.

*High Legalism Discredited*

The legalistic test was a product of an unfortunate phase in the development of tax law which, one might have hoped, had been decently interred. But, like liberty, a balanced approach to delegated decision-making in taxation is only secured by constant vigilance. Disturbing signs of a return to the bad old days have started to surface. The pressures on legal decision-makers to play these legalistic games is enormous and it is hard to maintain the rage. Recent authorities are seeing the gradual encroachment through the backdoor of the fiscal nullity debate and through some of the s. 51 purpose arguments, of the sorts of legalistic ideas so thoroughly discredited in the 1970s.

*Europa Oil (N.Z.) Ltd v. Inland Revenue Commissioner (No. 2)*,[7] is the high water mark of the judicial tide of legalism. In response to the backlash against the tax schemes of the 1970s there was a far-ranging shift away from these more extreme positions. This has had a substantial impact on the law in the deductions area. As the law used to be stated, an expenditure was deductible if there was, on a strict and narrow analysis of the contractual rights, a direct connection between the expenditure and the production of assessable income. Thus if a family company incurred a $1 million expenditure to a related entity to purchase an item

[4] (1949) 78 C.L.R. 47, 56.
[5] (1935) 54 C.L.R. 295, 309.
[6] (1937) 57 C.L.R. 695.
[7] [1976] 1 All E.R. 503.

of trading stock which might be purchased for $1 in the marketplace, trading stock admittedly necessary to earn assessable income, on a strict reading of earlier authority, it might be said to be deductible. Of course, such a rule was so obviously susceptible to manipulation that it could not be taken seriously, and the judges would bail themselves out of extreme cases by the stratagem of stating boldly that a grossly excessive expenditure was not incurred to earn income or, after *Federal Commissioner of Taxation v. Phillips*,[8] that it was unreasonable. The only trouble was, they didn't explain why a solid mark-up for shoes or petrol, siphoned off to a related entity for tax avoidance, was not similarly characterized as not spent to earn assessable income.

Whilst the legalistic rule as described might sound like a caricature, the authorities did go great distance down this bleak road. Take the High Court decision in *Federal Commissioner of Taxation v. South Australian Battery Makers Pty Ltd.*[9] The scheme involved what amounted to a hire-purchase arrangement with the option to purchase exercised by a company loosely connected to the taxpayer, as part of the same group. The taxpayer (through intermediaries) leased property from the South Australian Housing Trust. In one typical year, the rent of $18,000 included a clearly identifiable element ($7,000) earmarked to pay off instalments of the purchase price. After a period of years, the option to buy the property (at a nominal amount) could be exercised by Property Options Pty Ltd. This company was a mere $2 nominee trustee company controlled by two accountants and holding the property in trust for another company in the Chloride Group, of which the taxpayer formed part. Property Options Pty Ltd could eventually be tied in, through an overseas holding company and a string of subsidiaries, to the taxpayer company, but was not directly owned or controlled by the taxpayer. The scheme involved claiming a deduction for the full rent, including the $7,000 property purchase element, and transforming it into a tax-free capital gain in the hands of another company in the Chloride Group. The scheme succeeded in the High Court. Of course, expenditure recoupment schemes of this type have now been dealt with by more than one generation of specific anti-avoidance provisions (s. 82KL and thereafter).

For present purposes, the main damage generated by the Barwick High Court's flirtation with high legalism was that it obscured more fundamental issues from a whole generation of lawyers, including lawyers in the decision-making structure, and hence brought about a long hiatus in the excellent early work of the Dixon High Court in elaborating the central gateway test. A plausible causal link between expenditure and production of income is not enough. An expenditure is not automatically deductible because the causal link is in triplicate and enforceable in a court. An expenditure is not automatically deductible because one million dollars was contractually secured for a widget, worth one dollar, even if the widget is badly needed to earn assessable income.

[8] (1978) 8 A.T.R. 786
[9] (1978) 8 A.T.R. 879

*Purpose an Unruly Concept*

The 'purpose' test is a restatement of the core concept in s. 51 that expenditure, to be deductible, must be incurred in producing assessable income. But the idea of 'purpose' is unruly and introduces its own ambiguities. Dixon J. warned of the dangers of substituting alternative formulas for that in s. 51 when he said, in *Robert G. Nall v. Commissioner of Taxation*:

> 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.[10]

The concept of purpose, mixing as it does subjective and objective factors and objectives of varying proximity, is of such ambiguous connotation that it invites undisciplined analysis. This in itself, as Dixon J. warned in that prophetic language in *Nall*, makes it dangerous to substitute shorthand terms for the actual language in the statute. While human beings will invariably use such terms as shorthand, when such terminology is mobilised as the major premise in serious analysis of the core concepts of s. 51, it almost begs to undermine clarity of analysis. In the context of legal judgments, words get a life of their own.

The nature of the problem is clear from an analysis of the reasoning of Yeldham J. in *Grant v. Federal Commissioner of Taxation*[11] where he discusses whether a share trader under a *Curran*[12] scheme is carrying on a business and can deduct the normal expenses of that business. He reasons that the subjective purpose of the taxpayer to derive a tax benefit is irrelevant under s. 51. He focuses on the issue of whether the expenditure was incurred to produce assessable income. When he uses the words 'the fact that the motivating force is the desire of the person . . . to obtain allowable deductions' and says that 'motive as distinct from purpose is irrelevant'[13] his meaning becomes clear. While denying the efficacy of some broader doctrine of sham or fiscal nullity (which argument it is unnecessary to resolve for present purposes), he concedes fully that the proximate ends which moved the particular expenditure at issue are a critical criterion of deductibility. Thus, if we are to be strictly accurate, under Yeldham J.'s view, purpose is at the same time irrelevant (if it refers to the total purpose of the scheme) and very relevant (if it refers to sufficiently proximate ends of the expenditure).

If we are analysts searching for a reasonable and workable test, as opposed to lawyers playing word games with these imprecise terms to the advantage of their case, it sticks out a mile how easy it is to fasten onto that ambiguous word 'purpose' and use it to draw out propositions which are manifestly in conflict with the main thrust of the provisions. Unhappily, analysis of s. 51 has not been characterized over the years (by either judges or academics) by the careful construction of a principled framework, and these elementary mistakes are not difficult to find. With the greatest respect, general statements, to the effect that 'purpose is irrelevant to the first [limb of s. 51]' by Lusher J. in *Creer v. Federal*

[10] (1937) 57 C.L.R. 695, 712.
[11] (1985) 17 A.T.R. 144, 154.
[12] (1974) 5 A.T.R. 61
[13] (1985) 17 A.T.R. 144, 154.

*Commissioner of Taxation*,[14] do nothing to assist in clarifying such confusion. It is only in authorities such as *Ure v. Federal Commissioner of Taxation*,[15] *Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation*[16] and *Gwynvill Properties Pty Ltd v. Federal Commissioner of Taxation*[17] that we see, admittedly early and as yet rough and ready, attempts to develop principled guidelines to give operational effect to the core formula in s. 51.

Similar problems are obvious in the attempts by the Federal Court to resolve problems in the reasoning of the Administrative Appeals Tribunal in *Federal Commissioner of Taxation v. Reed*.[18] This case turned on an attempt by the taxpayer to split income with his wife by buying a pharmacy business in their joint names. The Commissioner attacked the reasoning of the Tribunal, to the effect that it did not matter that the taxpayer was 'motivated to assist his wife to increase her income or even to reduce the level of his income tax below what if might have been had he purchased the new business and operated it himself'.[19] Foster J. simply held that this passage did not indicate that such matters were totally excluded from consideration by the Tribunal.[20] The reasoning accepts that wider purposes are relevant but avoids spelling out the extent to which they should be factored into decisions. It thus glosses over the key outstanding issue.

Questions of purpose and the taxpayer's subjective state of mind are in many ways a red herring. Section 51 clearly requires an inquiry into the objectives of an expenditure, that it must be spent to earn income. A subjective inquiry can never be completely satisfactory because only higher beings know what goes on in the minds of humans. Indeed is it really the core of what we are looking for? Some allowable deductions, for example those for theft of business assets, or business debts created when debtors get sequestration orders, are and clearly should be allowable without any taxpayer volition. Therefore, such a hypothesis about 'purpose' might be viewed more convincingly as a short-hand for characterization of an expenditure by an objective observer. It will be remembered that the old general anti-avoidance provisions in s. 260 actually used the concept of 'purpose' and Lord Denning in *Newton v. Federal Commissioner of Taxation*[21] substituted an inference, a predicate, based on the objective facts.

Many formulas have been developed in the attempt to give coherence to the statutory formula. Other formulas adopted in the authorities are variants of the main test and include the object which the taxpayer had in view,[22] the result aimed at by the taxpayer[23] and the reason for the expenditure. Some have simply abandoned a search for principle and asserted the deductibility issue is a mere question of fact.[24]

[14] (1985) 16 A.T.R. 246, 250
[15] (1981) 11 A.T.R. 484.
[16] (1980) 11 A.T.R. 276.
[17] (1986) 17 A.T.R. 844.
[18] 88 A.T.C. 5014.
[19] *Ibid.* 5022.
[20] *Ibid.* 5023.
[21] (1958) 7 A.I.T.R. 298.
[22] Latham, C. J., in *W. Nevill & Co Ltd v. Federal Commissioner of Taxation* (1937) 56 C.L.R. 290, 301.
[23] *Ibid.* 308, *per* McTiernan, J.
[24] *Federal Commissioner of Taxation v. Brixius* 87 A.T.C. 4963 and numerous other authorities.

*Apportioning Expenditures*

The central legislative formula says expenditures are deductible 'to the extent' that they are spent to earn assessable income. Clearly expenditure must be causally linked to the production of income. This is a necessary condition but it is not a sufficient condition for deductibility. Once we reject the legalistic approach of the 1970s and return to the mainstream of earlier case law we open the can to some difficult apportionment dilemmas. This is much more than a calculation problem. It raises critical issues about the operation of the central gateway test.

The danger with a test based on apportionment is that it encourages decision-makers to assume that they can ascribe each dollar of expenditure to the production of assessable income or to other outcomes, and then divide up the amount spent. It reintroduces, in another form, the assumption that if expenditure is causally relevant to the production of assessable income then it is necessarily deductible. But this leaves out an essential element. Having ascribed the dollars of expenditure to the appropriate pigeon-hole we still need to show that the 'essential character' of that part of the expenditure was income-earning. A whole second layer of reasoning must be brought to bear.

Thus, while the apportionment approach has much to recommend it, and is clearly necessary to unscramble composite expenditures used as the basis of many tax avoidance schemes, it ought to be treated with caution as the foundation of the central gateway test. First, there is the problem in principle of deciding whether some expenditures with obvious causal links to the production of assessable income (*e.g.* business clothes, entertainment *etc.*) but which nevertheless add substantially to the taxpayer's personal utility ought to be deductible. The over-riding task is not the mechanical application of the deductibility formula in s. 51 but the more fundamental question about whether such expenditures with an undoubted causal link to the production of assessable income should, for that reason alone, be deductible. These wider dilemmas must not be submerged in mechanistic application of verbal formulas. Second, there is the sheer administrative task (which becomes prohibitive in mass decision-making areas like business entertaining, travel *etc.*) in unravelling the threads. Often some arbitrary apportionment will optimize the overall justice of the deduction regime. Purists should be mindful of the danger that, where a line cannot be held on proper and administrable criteria or is based on the availability of facts to the decision-maker which it is not practical to ascertain, the practical result will be to allow the well-advised taxpayer open season on the tax base. The second-best realities of the practical world must be very high in our consciousness as we develop rules for the real world. It must be stressed that such 'pure theory', which, in constructing its own abstracted universe, excludes significant real-world outcomes, is simply bad theory. Theory is a good servant if it gives coherence to reality, but a bad master when it obscures reality. This is not a marginal issue. It is at precisely these weaknesses that the main fire power of tax avoiders has and will be directed.

The Federal Court decision in *Ure v. Federal Commissioner of Taxation*[25]

[25] (1981) 11 A.T.R. 484.

dealt with an income-splitting scheme in which the taxpayer borrowed money at high rates of interest and on-lent at low rates so he could claim a deductible loss. The taxpayer, a solicitor, borrowed three separate sums totalling round $66,000 at interest ranging from 7.5 per cent to 12.5 per cent. He on-lent these sums at 1 per cent interest to his wife or the trustee of the family discretionary trust (controlled by the taxpayer and his wife).

The Federal Court held that the interest was not fully deductible. The Court apportioned the payments of interest partly to the earning of the 1 per cent interest paid by the wife and family trustee (which was clearly assessable income). The rest was incurred to dodge tax. The leading judgment of Brennan J. is a model of understated clarity. In response to the question whether it was accurate to say that the 7.5 per cent to 12.5 per cent interest was incurred to earn 1 per cent return, he replied:

> The answer to that question does not turn directly upon the disparity in interest rates, but upon an examination of the purposes for which the money was laid out. The disparity of interest rates is itself eloquent to suggest the existence of purposes ulterior to the earning of interest at the rate of 1 per cent per annum and the evidence confirms the existence of further purposes [namely, of siphoning money to the wife and family trust].[26]

Brennan J. emphasized that the inference about the purposes was an issue of fact turning on the objective circumstances, indicating, as the earlier decision in *Magna Alloys*[27] showed, that all the circumstances were relevant. Deane and Sheppard JJ. indicated that, had apportionment not been possible, they would have disallowed the expenditure. While the earning of the 1 per cent interest was *an* object, it was misleading to say that it was *the* object. The dominant objectives were the indirect objects (another euphemism for tax dodging) which were not of an income-earning character.

The decision in *Ronpibon*[28] is clear authority for the proposition that apportionment is both authorized by s. 51 and, indeed, that the wording of s. 51 was deliberately changed from the 1922 Act so that apportionment could take place. Composite expenditures were apportioned to different objects in *Inland Revenue Commissioner v. Europa Oil (N.Z.) Ltd (No. 1)*.[29] In *Adelaide Racing Club Incorporated v. Federal Commissioner of Taxation*[30] Owen J. in the High Court apportioned an expenditure. The taxpayer club held leasehold land on which it ran its horse-racing. It claimed deductions for improvements to the land, for items like building a new members' stand and reconstruction of part of the actual racing track. Because of the principle of mutuality, receipts from members' subscriptions were not treated as assessable income, but as the general public also used the course, receipts from this source were assessable. Owen J. upheld the Commissioner's apportionment based on a dissection which disallowed expenditures directly on members' facilities (mainly in the members' stand), allowed expenses incurred exclusively for the public, and fairly apportioned the balance in the proportion of members' subscriptions to total receipts. Why was

[26] *Ibid.* 488.
[27] (1980) 11 A.T.R. 276
[28] (1949) 78 C.L.R. 47, 55.
[29] [1971] A.C. 760.
[30] (1964) 9 A.I.T.R. 404.

the capital exception not invoked for these expenditures? More recently, the Federal Court in *Federal Commissioner of Taxation v. Carberry*,[31] while accepting that apportionment was legitimate, accepted the Administrative Appeals Tribunal's characterization approach.

As with any other expenditure, the deductibility of interest paid out to borrow money turns on what it is spent for. This will, in turn, depend mainly on the use of the borrowed money. The leading decision is the High Court decision in *Federal Commissioner of Taxation v. Munro*.[32] In this case, the taxpayer borrowed £30,000 from a bank secured by a mortgage on some land and a building in Elizabeth Street, Melbourne. The buildings were let to tenants for rent totalling over £2,500. £20,000 of the borrowed money was used to form and buy shares in a similar land holding company in New South Wales. Nine thousand £1 shares were allotted to each of the taxpayer's two sons. The taxpayer retained two thousand.

The High Court, comprising Knox C.J., Isaac, Higgins, Gavan Duffy, Rich and Starke JJ., held that the interest on the borrowed money was not deductible under the predecessors of s. 51.[33] Knox C.J. delivered the leading judgment. He held that, even though the loan was secured on income-producing property,

> [t]he interest was paid not for the purpose of gaining or producing assessable income of the taxpayer, but for the purpose of satisfying a debt which the taxpayer had incurred with a view to the production of income by the company for the benefit of its shareholders.[34]

Isaacs J. put it more strongly:

> The taxpayer had already acquired and held his property as a rent-producing property. Nothing more was necessary to gain or produce that income. Then he chose for purposes quite alien to that property to borrow money. Had the money borrowed been expended on the property so as to increase rental or so as to prevent depreciation which would have reduced the rentals, then it could have been properly said the interest had been a means of gaining or producing the assessable income. But in employing the borrowed money for purposes independent of the property that result cannot be postulated.[35]

He held it was not incurred to create any assessable income but to create a new enterprise owned and conducted mainly by persons other than the taxpayer. Since the old provisions required expenditure to be wholly and exclusively incurred for the production of assessable income, *Munro* must be treated with caution. But it supports the reasoning of the Federal Court in *Ure*.

In *Federal Commissioner of Taxation v. Janmor Nominees*,[36] Lockhart J. delivering the leading judgment of the Federal Court, refused to apportion deductions on a negatively geared property. The taxpayer company was trustee of a family trust. It bought residential property which it leased to a beneficiary at a commercial rent. The property was financed by a mortgage and the interest and other expenditures exceeded the rent, total rent being around $7,000 and total expenditures around $19,000. Lockhart J. distinguished *Ure* and reasoned that if the interest had been less than the rent then it could not have been seriously argued that it was not deductible.[37] He could see no difference because the

31 88 A.T.C. 5005, 5008.
32 (1926) 38 C.L.R. 153.
33 ss. 23 (1)(g) and 25(e) of the 1922 Act.
34 (1926) 38 C.L.R. 153, 171.
35 *Ibid.* 197.
36 87 A.T.C. 4813.
37 *Ibid.* 4822-3.

interest payments were much higher than the rent. While conceding that s. 51 allowed dissection or apportionment if the expenditure had a mixed domestic and income-earning character, he could 'see no support for any such arbitrary division' on the facts before him. The obvious rebuttal is that the expenditure might have been incurred to generate income on which tax was postponed or capital profits made. Where expenditure exceeds assessable income, it might well be incurred as a long-term investment in future cash flow. This might raise timing nexus or capital problems. Be that as it may, it also raises the rebuttable presumption that the taxpayer might benefit from selling off the capital asset at an enhanced value. The essentially arbitrary nature of the apportionment can hardly be an argument for refusing apportionment if it is otherwise mandated. Most attempts to quantify complex and interlinked choses in action will require such judgments. The preferable practical solution might be to allow expenditure against assessable income of that type in the year in question and to carry forward the excess against future assessable income. This also has the virtue of setting expenditure dollars against income dollars of the same time-discounted value and promotes the ideal Dixon J. propounded in *Carden*[38] of a correct reflex of profit. This reasoning clearly lays down the battle lines for the larger questions of the future.

In 1984 the Deputy Commissioner in Victoria issued a ruling attempting to disallow deductions for negative gearing. This was not proceeded with at the time. However, legislation was introduced in 1986 to deal with negatively geared investment housing. This area became a political minefield and further legislation was introduced to allow negative gearing. Similar problems arise with negatively geared primary production and corporate takeovers.

The approach in *Ure* is supported by the older authorities. In *Aspro Ltd v. Commissioner of Taxation*,[39] the Privy Council considered an appeal from New Zealand. The taxpayer company paid £10,000 in directors' fees to two directors. The directors lived in Melbourne and the company operated in New Zealand. Neither had visited New Zealand in the relevant year. There was complete identity of shareholders and directors (and thus lack of an arm's length relationship). Both directors were directors of the Australian parent company. The only evidence was the bare fact of the company resolutions and lack of visits. Neither director gave evidence or gave information about how long he had spent in New Zealand since the inception of the company. The Commissioner disallowed £8,000 of the expenditure under the New Zealand analogue of s. 51.[40]

Lord Thankerton, delivering judgment for the Privy Council, refused to interfere with the disallowance. In the event, most of the expenditure was not deductible. The case turned largely on a failure of the taxpayer to discharge the onus of showing (the onus being on the taxpayer) that the £10,000 had been incurred to earn assessable income. The case demonstrates authoritatively a

38 *Commissioner of Taxes (S.A.) v. Executor Trustee and Agency Co. of South Australia Ltd* (1938) 63 C.L.R. 108.

39 [1932] A.C. 683.

40 s. 80(2) of the Land and Income Tax Act 1923, which spoke of expenditure 'exclusively incurred in the production of assessable income'.

willingness to look at all the circumstances, and a willingness to penetrate beyond a bare consideration of the legal position and the causal connection. The judges test this legal position critically and look at all the facts in deciding upon the proper characterization and appropriate apportionment of the sum in question. Note that in Australia, s. 109 imposes a statutory limit on fees paid by private companies to their shareholders and directors. The Commissioner is given a discretion to disallow remuneration or allowances which exceed a reasonable amount.

In *Robert G. Nall Ltd v. Federal Commissioner of Taxation*,[41] the High Court, relying on *Aspro*, disallowed most of a £2,500 salary paid to a governing director. Under a take-over arrangement (which transferred Nall's business from an earlier company), the taxpayer company guaranteed Nall a salary of £2,500 for life as governing director. From 1928, the active business of printing and manufacturing stopped, and the accountants carried on the company to manage its assets. An accountant carried out most of the work and Nall's functions were relatively minor. The Commissioner disallowed £2,000 of the £2,500 deduction. The case dealt with the test in s. 25(e) of the 1922 Act.

The reasoning of a strong High Court, in which Latham C.J., Starke, Dixon, Evatt, McTiernan and Rich JJ. all gave judgments, was largely ignored during the 1970s. The judges were prepared to look critically and objectively at all the circumstances, and at reality (as opposed to a limited 'legal reality'). Take the reasoning of Rich J. in the lower court, expressly affirmed in the Full Court:

> In each year of income in respect of which the deduction is claimed the question must be: What was the reason or occasion for the payment? Was it laid out for the production of income or was it made for some other reason? If the company were guided solely by business considerations and . . . had nothing in view but the profitable conduct of the company's affairs, it is to my mind quite clear that [things would have been arranged differently]. A salary of £2,500 a year is out of all proportion to the demands made by the company's transactions upon the time and capacity of the person directing its affairs. I have no hesitation in attributing the continuance of the remuneration to other motives than those of business.[42]

Latham C.J. said:

> The question is, in my opinion, whether there was a real connection between the expenditure and the income produced. In the case of a company carrying on a business and existing for the purpose of making profits, the question is whether the expenditure has a real relation to the profits sought to be gained. If the expenditure, in the circumstances of a particular case, is not shown to be wholly and exclusively connected with the production of income, then the expenditure cannot be said to have been wholly and exclusively laid out or expended for the production of the income. Where, therefore, in the case of the director of a company, there is evidence from which the conclusion may be drawn, and the conclusion is drawn, that there is a great disproportion between the expenditure and the services rendered in the business of the company, the expenditure cannot be regarded as being so made. This, in my opinion, is the effect of the decision in *Aspro Ltd v. Commissioner of Taxes*.[43]

Dixon J. adopted the realist approach which saturated the other judgments, and supported it with an attack on the arguments which formed the basis of the legalistic test in decisions like *Europa (No. 2)*, constructed on the so-called 'legal character of the payment'. He said:

41 (1937) 57 C.L.R. 695.
42 *Ibid.* 699-700.
43 *Ibid.* 706.

> [W]hen it is said that gaining or producing assessable income must be the purpose of the expenditure if its deduction is to be allowed, no more can be meant than that the circumstances of the transaction must give it the complexion of money laid out in furtherance of a purpose of gaining income . . . 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. The case of *Aspro Ltd v. Commissioner of Taxes* makes it sufficiently plain that a company does not become entitled to deduct a sum as exclusively incurred in the production of assessable income simply because it is a payment of directors' fees lawfully fixed under the articles of association. There must be a further connection between the payment and the production of the company's revenue. In the present case there is, I think, no sufficient relation . . .[44]

Note also the recent Federal Court decision in *Telecasters North Queensland Ltd v. Federal Commissioner of Taxation*[45] in which Spender J. wholly disallowed retiring allowances paid to directors because it was a payment for past services and did not have the requisite connection to the earning of assessable income.[46]

### *Essential Character Test*

*Lunney v. Commissioner of Taxation of the Commonwealth of Australia*[47] dealt with the claim for the deduction of the expenses in travelling from home to work. Were such travelling expenses incurred in producing assessable income? The case consolidated the appeals of a wage earner and a professional, a dentist. The claims of both taxpayers were rejected by the High Court of Australia. Williams, Kitto and Taylor JJ. delivered a joint judgment. The Court drew on the familiar distinction between necessary and sufficient conditions. It rejected a test which rested deductibility on the basis that assessable income could not have been earned without the expenditure. Rather, the Court stressed the 'essential character' of the expenditure and its relevance to the scope of the operations. The Court drew on the United Kingdom authorities[48] and summed up their reasoning in the following words:

> 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 characterized 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.[49]

While the learned judges obviously had a clear idea in their own minds of the concept of 'essential character' of an expenditure, does such a label give useful guidance in solving practical problems? It is not clear whether they had a temporal-spatial nexus in mind, analogous to the much maligned concept of 'arising out of and/or in the course of employment' from workers' compensation, or a form of characterization based on some essential attribute of the advantage

[44] *Ibid.* 712.
[45] 89 A.T.C. 4501.
[46] *Ibid.* 4508.
[47] (1958) 100 C.L.R. 478.
[48] citing *Newsom v. Robertson* [1953] 1 Ch. 7, 16.
[49] (1958) 100 C.L.R. 478, 499. Emphasis added.

acquired with the expenditure. Does this test help us when we deal with our earlier examples?

All of the expenditures in the examples can be linked 'causally' to the earning of assessable income. If we look at the facts, unhampered by a legal framework, it is manifest that all of them can be linked in a quite plausible way to an increase in the personal utility of the taxpayer or to the compensation for attributes peculiar to the taxpayer. The problem becomes particularly acute in a case where the taxpayer engineers a scheme for tax purposes to siphon money to his family trusts to avoid tax.

It is clear that a causal characterization within a rule model and unsupported by any criteria from outside the model does not advance the search for useful guidelines to help solve problem cases. Causal tests project a comforting aura of scientific rigour. But it is an illusion in the context of problem cases. A causal chain has many links. The links one chooses to emphasize and to ignore turn on the initial theory with which one starts. When dealing with the artificial world of legal explanation we have no widely accepted criteria enabling us to choose between competing causal explanations. In this universe of problem cases, if we are serious about developing principled procedures for rule creation, there is rather more utility in openly acknowledging the range of choices and in setting out to articulate those elements in our legal culture responsible for our causal preferences. We should examine those theories directly rather than second-hand as unarticulated premises in a causal analysis.

In *Inland Revenue Commissioner (N.Z.) v. Banks*[50] the New Zealand Court of Appeal challenged the process of characterization in *Federal Commissioner of Taxation v. Faichney*[51] where home office expenses were denied deductibility on the basis that 'a study in a taxpayer's home, no matter how great the extent of its dedication in point of use to the pursuit of those activities from which the taxpayer earns his income, is part of that home'.[52] The New Zealand Court of Appeal held that it is not the character of the initial outlay on which the court should focus but the particular use of the asset for which the deduction is sought. This was to be tested in the income year in question. They rejected a blanket characterization of premises as a home or business.

The basis for the Australian view, recently reaffirmed, might be that administrative constraints make it too expensive to check reliably on all such minor claims for deductions, given the realities of self-assessment in a mass decision-making process and computer methods in the Tax Office. Thus, the best approximation is to refuse them all, or to give some arbitrary unsubstantiated compromise limit in lieu of actual deductions. Such an argument would then be available for a whole range of business deductions presently allowed; if this was the basis of the Australian decisions, it should have been openly articulated and justified.

50 (1978) 8 A.T.R. 421.
51 (1972) 129 C.L.R. 38.
52 *Ibid.* 43.

The decision delivered by Richardson J. for the Court of Appeal in *Banks* sets up a useful challenge to the Australian decisions, and a timely caution about excessively rigid rules. The following points extract some of the relevant features of the structure developed. It was noted that there is 'an understandable unwillingness in the cases to attempt to establish hard and fast rules to cover all situations . . . in an area of the law which, so far as possible, should reflect commercial realities'.[53] It was reasoned that this is not an area where it is 'possible to devise a judicial formula which, as a substitute for the statutory language, could be applied in all cases'.[54] Decisions must be reached in particular cases by applying statutory language to the particular circumstances.[55] The focus of the inquiry necessarily shifts and the provision must 'involve an amalgam of provisions'.[56] The nature of the assets acquired with the expenditure in *Lodge v. Federal Commissioner of Taxation*[57] were 'inherently of a private rather than a business character', but expenditures such as insurance, rates *etc.*, as in *Faichney* or *Banks*, do not inherently have such a character.

### Magna Alloys: *Foundation of the Modern Test*

The leading authority which pulls together the threads in the modern test is the Federal Court decision in *Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation*.[58] The taxpayer company sold welding equipment, maintenance services for sophisticated machinery and the like to industry. Three directors in the taxpayer company were convicted on a charge of conspiracy and fined $2,000. Three agents were also convicted. The charges arose out of the allegations of investigative journalists that the directors were giving payola to company officers and public servants as an inducement to use their products. The taxpayer company incurred almost $300,000 legal expenses in defending the charges. They sought to deduct these legal charges. The Full Court of the Federal Court, comprising Brennan, Deane and Fisher JJ., relied on the second limb. They held the legal expenses deductible.

The really important point was that the company had no legal obligation to pay these expenses. They arose from a moral obligation or sound business practice. In the process of relying on a broader test, the judges were forced to articulate a more coherent basis for the central gateway test. The test is whether the expenditure is *appropriate* as a business expense. This is predominantly a characterization test, rather than one relying on close dissection of the expenditure and its detailed relationship to particular items of assessable income.

In going through the characterization process there is some divergence in formulation which may prove to be significant. Brennan J. said that purpose is not the test but 'the purpose of incurring the expenditure may constitute an

53 (1978) 8 A.T.R. 421, 425
54 *Ibid.*
55 *Ibid.*
56 *Ibid.* 426.
57 (1972) 3 A.T.R. 254.
58 (1980) 11 A.T.R. 276.

element of its essential character, stamping it as expenditure of a business or income-earning kind'.[59] He relies on 'controlling factors': analysis of the advantage sought; and the connection between the advantage and the taxpayer's income-earning business (or, in the case of the first limb, the income-earning process).[60] Thus he does not see evidence of a subjective state of mind as controlling, but it does have a 'significant evidentiary role', and may be determinative in a particular case where there is no contractual relationship.[61] Of course, in most routine cases, inferences about whether the expenditure was incurred to earn income will be obvious from the legal rights and obligations created.

Deane and Fisher JJ. said that the central controlling factor is whether the outgoing is, in the circumstances, 'reasonably capable of being seen as desirable or appropriate from the point of view of the pursuit of the business ends [or for the process carried out for the purpose of earning assessable income]'.[62] The test of 'reasonably capable of being seen as appropriate' involves an active judicial assessment of whether the expenditures were made to earn income. It eschews a pedantic test, or one based on an immediate direct purpose, in favour of a balanced assessment of the circumstances. Deane and Fisher JJ. put more emphasis on viewing the circumstances objectively and drawing inferences from the actions of the parties. They adopted Fullagar J.'s approach in *Federal Commissioner of Taxation v. Snowden and Willson*[63] and stated that 'within the limits of reasonable human conduct' the taxpayer must decide what is necessary.[64] It is one thing for the Commissioner to look at the amount of the expenditure and all the circumstances to draw the inference that it was not spent to earn income. But it is a completely different thing to assume that the Commissioner can substitute his own judgment for that of the taxpayer on *bona fide* business expenses. The enquiry goes only to whether the expenditure can fairly be characterized, in all the circumstances, as expenditure spent to earn assessable income. To assert the validity of this proposition is in no way to concede the further proposition that, once this threshold is established, it is open to the Commissioner to disallow parts of the expenditure solely on the basis that a more prudent businessman might have incurred less.

Clearly, in making the characterization and drawing out inferences about controlling factors, the court is not limited to legal or contractual rights. Brennan J. did say that if these are sufficient to identify an advantage to the taxpayer, then the court need go no further.

A bizarre modern application of this wide *Magna Alloys* test appears in the 1989 Federal Court decision in *Jezareed Pty Ltd v. Federal Commissioner of Taxation*.[65] In this decision Ryan J. allowed the deduction of consultant's fees

[59] *Ibid.* 282.
[60] *Ibid.*
[61] *Ibid.* 284.
[62] *Ibid.* 297.
[63] (1958) 99 C.L.R. 431.
[64] (1980) 11 A.T.R. 276, 295.
[65] 89 A.T.C. 4459

for a sales tax avoidance scheme on the basis that, if effective, the cost of trading stock 'was reduced by almost the whole amount of the sales tax otherwise assessable'[66] and 'viewed objectively, the payment of fees for the implementation of the scheme was reasonably capable of being seen as desirable or appropriate in the pursuit of the [taxpayer's] business . . . being carried out for the purpose of earning assessable income.'[67]

*Modern Gateway Test*

Central to s. 51 and to the operation of the Australian deduction system is the question of whether expenditure was spent to earn assessable income. All expenditures must pass through this central gateway before they can hope to reach the promised land of deductible status. Just how closely and in what ways must a deduction be tied to the production of income before the courts will allow a deduction?

For all its inexactness, the essential character test (frequently smuggled in as purpose) probably forms the most promising base for future evolution of the law. Dixon J.'s warning in the *Robert G. Nall Ltd* case about the dangers in seeking an excessively exact or logical meaning, and seeking instead a practical attempt to match income and the legitimate costs of earning it get to the essence of it. The characterization test is helpful, *provided* it is seen as the starting point rather than the end of a process of legal evolution in this critical area, and *provided* it is sensitively balanced against the apportionment test. To pull out the threads and to advance the analysis:

(1) The central gateway test is whether expenditure was spent to earn assessable income. This will be decided on the basis of a broad characterization. Can the expenditure be labelled, in all the circumstances, as appropriate to the process of earning assessable income or reasonably capable of being stamped as an income-earning expenditure? Or is it more appropriately labelled as an expenditure spent for the taxpayer's personal enjoyment or other non-assessable income outcomes? The characterization will be made on the basis of direct and indirect benefits to the taxpayer.[68]

(2) In making this characterization the decision-maker must look actively and critically at the particular expenditure in the context of the entire transaction and all the circumstances. Was the expenditure spent to earn assessable income or for some other outcome? What, using a hard-headed assessment of all the advantages flowing from it (legal and non-legal), was it spent for? Can it reasonably be inferred, on a practical assessment of all the circumstances, that the expenditure was laid out for an objective other than earning assessable income? Was that other objective a material factor in moving the expenditure? Beyond this point it is necessary to proceed with caution with this mechanistic test. By trying to build too much intellectual superstructure

[66] *Ibid.* 4461.
[67] *Ibid.* 4462.
[68] Gibbs, J., in *Federal Commissioner of Taxation v. South Australian Battery Makers Pty Ltd* (1978) 140 C.L.R. 645, 660.

on the foundation of a nice simple verbal formula we can paper over more of the really tough issues than is prudent and descend rapidly into the fruitless pastime of counting angels on pinheads. The decision-maker is necessarily weighing policy choices. To pretend that these hard decisions are derived from verbal formulas is to invite bogus reasoning and confusion.

(3) It is now clear that a formal contractual relationship between expenditure and income is *not* essential for the deductibility of an expenditure.[69] Conversely, a contractual or other legally binding relationship is not *in itself* sufficient basis on which to uphold a deduction. Even where such a formal relationship exists, the courts will still insist on active intervention when addressing the critical question whether the expenditure was *in fact* spent to earn income. In recent cases the courts have gone a long way to over-reach a nexus established by formal contractual arrangements where a wider appreciation of all the circumstances gives a more cogent explanation for the expenditure. Where a relevant formal contractual relationship does exist this will normally establish the *causal* linkage between the expenditure and assessable income.

(4) If the reason for a significant portion of the expenditure or a significant outcome of the expenditure was other than the earning of assessable income it will not pass the central gateway test and the onus will then be on the taxpayer to establish that a significant portion of the expenditure can be related to, and separately identified as, an expenditure to earn assessable income. But the onus is against dissection, and dissection should still only be permitted where it is justified on a balance of the criteria articulated below.

(5) A residual question remains beyond the limits of these tests. How far does the characterization or apportionment test license judges or bureaucrats to penetrate into and query the quantum of expenditures? Is there a threshold condition which requires that, so long as the expenditure is plausible and commercially realistic, it is not permissible to impugn it? The earlier authorities state that it is not for the Commissioner to tell a taxpayer how much he *ought* to spend, only how much he has *in fact* spent to earn income. These two issues are not mutually exclusive because active characterization of expenditures implies that the decision-maker does address the question whether any expenditure which purports to earn assessable income is really (on the basis of an active judicial examination of all the circumstances) spent for this outcome. But it is one thing to use a disparity in expenditure as a *prima facie* basis for finding a non-assessable income reason for the expenditure and quite another to assert that this, in itself, is sufficient basis to disallow an expenditure. If the expenditure is made in an arm's length normal commercial transaction, and there is no plausible basis for asserting any reason for the expenditure other than income earning, the Commissioner cannot substitute another expenditure

[69] *Magna Alloys*, (1980) 11 A.T.R. 276.

for that incurred. But it is quite misleading, relying on older authority, to assert that this head prevents the Commissioner from examining an expenditure where the objective facts indicate the expenditure is disproportionate to the earning of assessable income or is significantly moved by reasons other than the earning of income. Any of these factors may be sufficient, with the excessive expenditure, to act as a basis for the inference that reasons other than the earning of assessable income moved the expenditure.

(6) The Act, being based on principles of historical accounting, makes no attempt to distinguish between the present and discounted future values of cash flows. But under our basic test it is clear, in the wider context of an artificial pre-payment scheme, that the expenditure was incurred, not to earn assessable income but for some other reason. At some point along the spectrum, the central gateway test might be brought into play because it is manifest in all the circumstances that a 1990 dollar was not in fact spent to earn a discounted 1999 dollar. It is short of this extreme that the limits of the law will be tested.

(7) The aura of scientific rigour underlying characterization choices under s. 51 is largely an illusion. It involves hard choices which, whether the decision-maker chooses to articulate it or not, are driven by economic and other policy imperatives. If the legislature chooses to stop every loophole with legislation, this creates rigidity and compromises the coherence of the deduction regime.

(8) The future lies in elaborating s. 51 itself with a systematic programme of rulings which steadily particularize the core concept into an increasingly specific set of rules to cover major practical problems. This should be combined with a programme to make the law easily accessible to the main market sectors, with targeted rulings to consolidate the relevant principles and rules into a painstakingly crafted, coherent set of rules to guide self-assessment. These concepts must be marketed through carefully packaged publications.

(9) The plain and obvious fact, of course, is that many expenditures which can be causally related to the earning of assessable income have both income-earning and private outcomes. If a business person or professional entertains professional contacts or travels or reads books this may both advance their professional outcomes and lead to personal growth and gratification. If a mother puts her child in a child-minding centre while she works, this is both a fulfilment of her personal parental obligations and, for all practical purposes, a necessary condition to earning income. The adequate supervision of the children of working mothers also involves some issues of not inconsiderable social importance. If a leading executive commutes by helicopter from home to work, this is both a means of allowing him to enjoy living away from the city and a saving of valuable time for his firm. If corporate empires are built by deducting interest costs on takeovers, this is both a cost of earning the cash flows from the target company, a cost of generating anticipated capital gains and a substantial tax subsidy for that

particular expenditure. Many of these characterization decisions are essentially policy decisions which ought to be decided, essentially, on the basis that, on balance, it is or is not appropriate to forego substantial chunks of the tax base in these situations. The decision should be based on a systematic weighing of economic and distributional issues and some very practical administrative concerns. *Inevitably* tax deductibility provides a subsidy, a 'tax expenditure' (to use the technical term in an extended sense) for the activity in question. Attempts to sanitize these issues and present them either as something to be magically extracted from the words of s. 51 or to be derived from a scientifically spurious causal test must not obscure these critical policy decisions, law-making if you will, which must be made by delegated decision-makers (whether judges or bureaucrats or politicians).

(10) In practice detailed rules to determine deductibility will necessarily depend on more or less arbitrary apportionment or arbitrary limits which accord some fair recognition to the competing policy factors and feature in a realistic appreciation of the daunting administrative problems of trying to deal with such issues in a mass decision-making process. The sheer cost-benefit implications of deploying vast bureaucracies to deal with relatively insignificant deductions for travel or home offices or the continuing litigation involved in fine-tuning apportionment generates unacceptable transaction costs. In practice, because the transaction costs of exercising discretions loom so large, because ineffective attempts at fine-tuning create open-ended leakages of revenue, specific decisions on deductibility and modes of implementation must be developed for each market sector. To exclude these realities from model building is to exclude the most important determinant of real world outcomes. It is bad theory. Frequently such policy choices will need to be made in rulings or arbitrary unsubstantiated computer limits imposed on deductibility or it may be specific and arbitrary limits for trades or professions negotiated for each market sector. A criticism of bureaucrats or judicial rule-makers which is based on the argument that decisions are arbitrary or make law is essentially misdirected in this context. In the real world both arbitrary decisions and rules made by bureaucrats are inevitable. Section 51 delegates rule-making power to bureaucrats and judges. Such delegation within a coherent conceptual structure is not an abdication of the legislature's law-making power. In a fast changing, computerized, mass decision-making system based on self-assessment it is the optimal means of realising the legislature's mandate. The issue is not whether arbitrary decisions are made in a mass decision-making structure but whether the inevitably crude and arbitrary decisions are the best approximations, given the practical limits of fine-tuning in the mass decision-making process and the inevitable choice of evils this predicates.

(11) In giving operational form to these administrative imperatives, specific legislation has been enacted:

— to disallow entertainment expenditures altogether or, to charge expenditures to fringe benefit tax at the employer level;

— to require taxpayers to substantiate deductible expenditures and document the linkage to earning assessable income (and granting them an unsubstantiated deduction limit as a *quid pro quo*);
— to disallow non arms-length sales of trading stock at inadequate consideration (s. 31C) or transactions with associated persons (s. 65).

(12) In making practical deduction decisions, advance opinions or rulings, the following criteria should be factored into the deductibility decision:
— assessable income earned or reasonably anticipated from expenditure;
— amount deducted;
— nature of advantage for taxpayer's income-earning process flowing from the expenditure and the manner in which the advantage will be used in the income-earning process or business;
— other non-assessable income advantages generated by expenditure;
— total cost to the tax base if deduction granted (including its precedent value);
— transaction costs and ability to administer rule effectively in market sector affected;
— relative suitability of other measures to deliver same benefits;
— impact on economic choices (level of investment, gearing, overseas borrowing *etc.*);
— distributional outcomes;
— specific social outcomes (is there implicit subsidy to families, working mothers *etc.*).

*Structural Features of Section 51*

Having analysed the crucial core concept, we can now go back to s. 51 and examine some of its structural features:

(1) Expenditures are deductible 'to the extent to which they are incurred in . . . producing assessable income'. This is normally called the first limb of s. 51. But one can doubt the continued utility of dividing s. 51 into limbs.

(2) In the case of business expenditures, there is a rather more loose causal test providing that expenditures are deductible 'to the extent to which they . . . are necessarily incurred in carrying on a business for the purpose of . . . producing [assessable] income'. This is normally called the second limb. Notice that it does not require the taxpayer to establish a direct causal or timing link between expenditure and a return in dollars of assessable income. It requires the less stringent link between an expenditure and an income-earning business. Recently this less restrictive second limb test has moved to centre stage, and the authorities have simultaneously read the first limb more widely so that it increasingly mirrors the less stringent causal test in the second limb. Under the second limb, it must be shown that the expenditure is necessarily incurred for the business and that the business is carried on to produce assessable income. While the second limb speaks of expenditure 'necessarily' incurred in an income-producing business, this term has been read right down in *Ronpibon Tin N.L. v. Federal Commissioner of Taxation*

to mean no more than 'clearly appropriate or adapted for' the income-earning business.[70] It does not deny deductibility to any item which can be related plausibly to purposes other than income-earning. The practical difference between the two limbs is thus of diminishing importance.

(3) There is a specific exception for expenditure of a private or domestic nature and expenditure incurred to earn exempt income. While these heads are occasionally relied on by the courts to disallow deductions or as a source of verbal sophistry, in truth they merely restate the obvious because such expenditures are not spent to earn *assessable* income. To promote clarity and cut down on unnecessary duplication, therefore, it would be better if judges dealt with these heads in the context of our discussions of the central gateway test.

(4) Losses are made specifically deductible under the terms of s. 51 and raise no peculiar problems. When deductions exceed assessable income the amount is deductible in the normal way under s. 51. In the year of income they can be set against other heads of assessable income in a prescribed order laid down in s. 50. This is generally only relevant for technical questions. Any surplus loss can, under s. 80, be carried forward for seven years. Care is required with company losses, as there are elaborate statutory requirements. Incidentally, expenditures are not deductible only if they produce assessable income. It is sufficient if they are incurred for this objective. Capitalism involves risk and the tax system does not, subject to the quarantine of deductions, deny deductions to those who fail.

(5) Capital expenditures are specifically disallowed. Since only income receipts are brought into assessable income, it is logical to mirror this principle by allowing deduction only of income or revenue expenditures. But note that capital gains brought into the tax base by the Capital Gains Tax catches capital expenditures. This permits qualifying capital expenditures, but only those directly relevant to the earning of 'capital' gains, to be brought into the capital gains cost base. These pass through a filter differently worded from s. 51 and do not, of course, need to display the income indicia. Of course, many capital expenditures can be deducted over the productive life of an income-earning asset through depreciation or accelerated depreciation.

(6) Bread and butter timing questions about the appropriate income year to claim deductions and losses, bad debts and depreciation are beyond the scope of this paper. The task is to get a fair reflex of the taxable income for a particular tax year and for this purpose treatment of receipts and expenditures should, so far as practicable, be based on detailed accounting principles. But it should be said at this stage that, as a general rule and subject to limited exceptions, mere accounting provision for future anticipated expenditure (like book entries for long service leave or holiday pay) is not deductible under the Australian Act until the time when expenditure is actually outlayed. However, recent authorities have made inroads on this rule.

[70] (1949) 78 C.L.R. 47, 56.

(7) Note that s. 82 prevents two deductions for the same expenditure. In practice, some deductions will be granted specifically (often with a monetary limit) and also be allowable under the general terms of s. 51. While s. 82 gives the Commissioner power to grant the deduction 'only under that provision which in the opinion of the Commissioner is most appropriate', in the normal case the excess will be deductible under s. 51. But there is potential for the sort of argument considered in *Reseck v. Federal Commissioner of Taxation*[71] that specific provisions exclude the general.

An important point, too often ignored, is that one must go to s. 51 before the authorities. Great care must be taken before applying United Kingdom authorities in this area. In the case of business income, the United Kingdom uses a general concept of profit, relying on accounting conventions supplemented by judicial law-making. This is in sharp contrast to the attempt in Australia to lay down a statutory basis for the deduction of expenditures. This applies for all areas save the new Capital Gains extensions and the old provision on speculative gains in s. 25A. Of course, under the new Capital Gains Tax, capital losses and expenditures will have their own rules.

*Timing Nexus: The Two Limbs Merge*

We turn to the simple question of timing. When a taxpayer makes an expenditure must it lead to the immediate earning of income? How remote, in terms of time, can those two events (incurring of expenditure and earning of income) be and still allow the deductibility of expenditure? This area does spill over into questions of income calculation (when is an expenditure *incurred*?) and the capital/income[72] dichotomy and it raises questions about the exact purpose of the second limb of s. 51. It is also true that much of the *dicta* from cases like *Ronpibon Tin v. Federal Commissioner of Taxation*[73] and *Amalgamated Zinc (de Bavay's) v. Federal Commissioner of Taxation*[74] have been taken out of context and hence have been misused in the context of the central gateway test.

The basic proposition until fairly recently was that the old cases on the first limb demanded a fairly strict temporal relationship between expenditure and the production of income, but this strictness was gradually eroded. In particular, there was no second limb to the old analogue of s. 51 in the 1922 Assessment Act and much of the job of relaxing a pedantic temporal link was done by judicial law-making grafted on the old first limb. The final abandonment of this strict temporal approach came as late as 1981 in the High Court decision in *Federal Commissioner of Taxation v. Smith*.[75] The old law was not utterly pedantic. It was not necessary to tie every expenditure closely to a particular derivation of assessable income. In particular, on the authority of *Ward v. Commissioner of*

[71] (1975) 5 A.T.R. 538.

[72] As we shall see, the test in the leading *B.P.* decision relied on how directly expenditure was tied to the income coming back dollar by dollar.

[73] (1949) 78 C.L.R. 47.

[74] (1935) 54 C.L.R. 295.

[75] (1981) 11 A.T.R. 538.

*Taxes*[76] it was not necessary to show that the expenditure for which a deduction was claimed produced income in the same tax year. But the old cases did require that an expenditure was incurred while an income-earning activity was on foot.

Whatever the position on the first point, after the enactment of the second limb, it was clear that, at least in the case of business taxpayers, such a pedantic view was not tenable. It was sufficient that the expenditure was incurred to carry on the business.

It was not until 1981 that the same point was settled for the first limb. In the important decision in *Smith* the taxpayer was an employee doctor. He claimed a deduction for a premium of $91 payable on a personal disability insurance policy. In fact, during the income year in question he had collected over $2,000 cover from the same policy following an accident. But the premium paid in the 1977-78 tax year was against possible income loss in future years. The High Court held, unanimously, that the premium was deductible. Gibbs, Stephen, Mason and Wilson JJ. wrote a joint judgment. Murphy J. wrote a short concurring judgment.

Significantly, the premium was deductible under the first limb. The benefits under the policy, as a monthly indemnity against income loss, were clearly assessable income under general principles (as well as s. 26(j)). The premium was clearly spent to earn that income. But was it sufficiently proximate to the income in point of time? Counsel for the Commissioner argued that the payment of each successive annual premium initiated a totally new policy and payments for each year had to be treated as separate outgoings. In the joint judgment the High Court rejected this argument:

> The section does not require that the purpose of the expenditure shall be the gaining of the income of that year, so long as it was made in the given year and is incidental and relevant to the operations regularly carried on for the production of [assessable] income.[77]

This amounts to a virtual incorporation of the temporal test from the second limb into of the first limb. The High Court judges went on to explain that there is no need for certainty that assessable income will flow from the expenditure, let alone any particular ear-marked dollars. One simply has regard to the 'nature and character' of the expenditure 'and generally to its connection with the operations which more directly gain or produce the assessable income'.[78] Merely because an insurance premium never actually produces income (the indemnity payment) is not fatal to deductibility.

In practical terms this amounts largely to an assimilation of the two limbs of s. 51. If the expenditure has sufficient nexus to the income producing process and is spent to earn income (as that causal connection is defined in *Magna Alloys* and the decisions discussed earlier) it is deductible without any detailed enquiry as to the temporal or even causal nexus to particular items of income. Thus restructured, the first limb bears a close resemblance to the second.

In earlier first limb cases like *Federal Commissioner of Taxation v. Finn*,[79]

[76] [1923] A.C. 145, 148.
[77] (1981) 11 A.T.R. 538, 542
[78] *Ibid.*
[79] (1961) 106 C.L.R. 60.

concerning the salaried architect who took extended long service and holiday leave to learn about European architecture, allowable deductions went well beyond the current income year and Dixon C.J. said that neither limb required 'a rigid restriction to the production of assessable income of the current year'.[80] Thus another plank in a rigid, formalist application of the Act seems to have fallen to the broad practical and contextual approach articulated by Dixon J. (as he then was) in that superb passage from *Carden's* case[81] in which he firmly identifies the function of these rules as one of producing a correct reflex of the periodic income from a continuing business. The United Kingdom authorities also hold that expenditure will be deductible even though no profit is expected that year[82] or even if no profits accrue at all.[83] Having swept aside, and properly swept aside, this rigidity, a new set of safeguards will be necessary to ensure that abuse is not facilitated with schemes to deduct in more valuable present dollars and earn assessable income in discounted dollars.

*Timing Nexus: Development of the Rule in* Amalgamated Zinc *and* AGC

The classic older authority on the temporal test is *Amalgamated Zinc (de Bavay's) Ltd v. Federal Commissioner of Taxation.*[84] From 1909 to 1924 the taxpayer company carried on the business of treating ore and tailings from a zinc mine in Broken Hill. It was liable to make annual contributions under special workers compensation legislation. The company's zinc treatment business was wound down from 1924 to 1929, the plant was closed down but the obligations continued well beyond. But the company's only business in the relevant year was handling investments. In each of the relevant 1932 and 1933 income years the company claimed over £1,000 in contributions.

The High Court disallowed the deductions. While Latham C.J. conceded that expenditure which did not relate to income of the same year could be deducted, this 'benevolent' interpretation was not sufficient to save the taxpayer. Dixon J., at this earlier stage of his judicial career, reasoned that the expenditure 'was completely dissociated from the gaining or producing of the assessable income of that year. The payment, in effect did no more than keep down an annual charge arising out of a business, which had closed'.[85] It was the 'entire lack of connection between the assessable income and the expenditure',[86] that the expenditure was not made in the course of the production of assessable income but quite independent of it which was critical.

The harsh decision in *Amalgamated Zinc* has come under progressive pressure in more recent years. But it was by no means clear that it was swept aside. The problem was that the important decision, the High Court decision in *AGC*

[80] *Ibid.* 68
[81] (1938) 63 C.L.R. 108, 154.
[82] *James Snook & Co. Ltd v. Blasdale* (1952) 33 T.C. 244.
[83] *Lunt v. Wellesley* (1945) 27 T.C. 78.
[84] (1935) 54 C.L.R. 295.
[85] *Ibid.* 310.
[86] *Ibid.*

*(Advances) Ltd v. Federal Commissioner of Taxation*,[87] was a case with special facts and that the refusal to follow *Amalgamated Zinc* could be attributed to any one of a number of factors.

The *AGC* case involved a tax avoidance scheme trafficking in bad debts. Before 1968 the taxpayer company (trading under a different name with different owners) was trading as a finance company. It got into financial difficulties and inspectors were appointed. They suspended its activities and organized a scheme of arrangement with its creditors. Its business was suspended for a year and a half. During this period the shares were sold to new owners, its name was changed to AGC (Advances) Ltd and, no doubt, its parent company injected part of its own profitable business into the taxpayer. The objective was to use the taxpayer's accumulated bad debts to soak up the profits of its parent's business. By systematically writing off bad debts (in one of the three relevant tax years exceeding $1 million) taxable income on the profitable business hived off into the taxpayer company could be reduced. There was no problem in claiming bad debts under s. 63 for hire-purchase instalments and 'hire charges' which were due and unpaid prior to 1968.

The problem arose with instalments in the repayment of principal which fell outside s. 63. It was sought to deduct these under s. 51. The majority of the High Court, comprising Barwick C.J. and Mason J., allowed the deduction. Gibbs J. dissented. It is not clear whether the special nature of this tax avoidance scheme and the special considerations explain the decision or whether it is of much more general application. In the leading judgment, Barwick C.J., in the course of his detailed reasoning, used the following criteria interchangeably to distinguish *Amalgamated Zinc*:

— *AGC* was concerned with losses, and the *Amalgamated Zinc* rule did not apply.
— There was a much more substantial break in the business in *Amalgamated Zinc* and hence there was not enough proximity between the income and expenditure. In *AGC* it was relatively short.
— The facts of *Amalgamated Zinc* were unusual and hence, presumably, were not of general authority.

It is very difficult, and ultimately unreliable, to single out any one factor. It is clear that Barwick C.J. was signalling a retreat from the *Amalgamated Zinc* decision. He argued, quite rightly, that losses may show up years after money has been ventured, that a loss from an accounting view must occur when the taxpayer accepts it is irrecoverable and it is 'not merely unjust but unacceptable to hold that it could not deduct'.[88] It is difficult not to apply this reasoning to the debt in *De Bavay's* is itself. The language, taken out of the context of this unusual decision, has hardly assisted systematic development of the law in this area.

Mason J., concurring, relied mainly on a passage from *Ronpibon Tin N.L. v. Federal Commissioner of Taxation*[89] to hold that, because of the second limb, the

[87] (1975) 5 A.T.R. 243.
[88] *Ibid.* 252.
[89] (1949) 78 C.L.R. 47.

temporal question was 'not foreclosed' by *Amalgamated Zinc* and that the High Court was at liberty to reach its own conclusion. In other words, that the second limb rendered *Amalgamated Zinc* irrelevant for business taxpayers. Looking at the issue from first principles, he decided that expenditures, if spent to produce assessable income, were deductible without division into accounting periods.

Gibbs J., dissenting, relied on the fact that there was a complete change in the business and shareholding. In other words, he relied mainly on the artificial nature of the tax avoidance transaction. So his reasoning is not of general application. In fact the legislature tried to deal with these types of schemes with anti-avoidance provisions in s. 63A (continuity of beneficial ownership required to carry forward bad debts), s. 63C (continuity of business required to carry forward bad debts) and in s. 80F. To take some of the practical consequences of the relaxed timing nexus rule, the following are deductible provided they are incurred in an ongoing business:

— expenditures to reduce future expenses and hence to increase assessable income of future tax years, provided the expenditure is not characterized as capital;[90]
— expenditures which are payments referable to the earning of income from earlier tax years;[91]
— expenditures to produce assessable income in future years;[92]
— expenditure preliminary to the starting of a business[93] or incurred as part of the cost of acquiring the business is not deductible.

*Timing Nexus: the* Ronpibon *Case*

The second limb of s. 51 speaks of deductions being allowable 'to the extent to which they are necessarily incurred in carrying on a business for the purpose' of producing assessable income. The provision was largely drafted out of an abundance of caution, because judicial law-making had largely stretched the first limb to cover the same ground. Nevertheless, the language in the decision in *Ronpibon Tin N.L. v. Federal Commissioner of Taxation*[94] has established it as the leading authority. But it is an authority which must be treated with great care. It has been the source of some confusion when its language has been taken out of context and read literally in the context of the central gateway test.

The law is that an expenditure in an ongoing business is deductible though not directly spent on producing income of that year. There is still an authoritative but shaky exception for expenditures where a business has ceased, and there is still a residual ground for disallowing expenditures where there is a 'considerable', possibly an unjustified, gap before the claim for a deduction.

The second limb was introduced to anticipate the sort of pedantic arguments which would disallow expenditures properly made for the production of assessable income merely because they were not directly related, in point of time, to

90 *W. Neville & Co. v. Federal Commissioner of Taxation* (1937) 56 C.L.R. 290, 301.
91 *Texas Co. (Australasia) Ltd v. Federal Commissioner of Taxation* (1940) 63 C.L.R. 382.
92 *Amalgamated Zinc* (1935) 54 C.L.R. 295, 309.
93 *Softwood Pulp & Paper Pty Ltd v. Federal Commissioner of Taxation* (1976) 7 A.T.R. 101.
94 (1949) 78 C.L.R. 47.

the production of income. In *Ronpibon* the taxpayer company[95] was a Melbourne company mining tin in Thailand. Business ceased upon Japanese occupation in the Second World War. But, no doubt in the wholly patriotic hope of ultimate Allied victory and a renewal of the business, the taxpayer company kept up its Melbourne office. Normal office expenses and salaries were incurred. At the time the company's only income was from fixed interest investments, and the Commissioner fixed 2½ per cent of the income from those investments as the appropriate expenditure for this purpose. In fact, that total income from securities was (in the 1940-41 year) only £1,000 and total income from tin in that year was £100,000. In the 1943-44 year total investment income was £1,833, the total deduction claimed for expenses was £1,206.

In a joint judgment, the High Court held that all but the £40-odd apportioned to investments was not deductible. It was not *just* a question of remoteness in time. First, there was no guarantee that the company would ever produce assessable income. The reason was because income from Thailand might very well be exempt[96] under provisions then in force granting complete exemption to offshore income which had already borne tax overseas.[97] Second, there was no guarantee the company would ever produce income. In effect, the maintenance of the company's administrative structure was a speculative capital expenditure based on the hope and expectation of future income. In fact, the Court's joint judgment referred to it as a 'concern of capital'.[98] This use of terminology is interesting because it indicates that the same factors are relevant to the question of the timing nexus and the question of whether the expenditure is of a capital nature. The reasoning on the first limb was rather half-hearted even though the Court chose to rest its decision on this limb. It must be remembered that the Court was primarily preoccupied with the problem of timing, but it was reasoned in the context of the uncertainties that assessable income would ever arise. The High Court said 'the words "incurred in gaining or producing the assessable income" mean in the course of gaining or producing such income'.[99] But this does not purport to be an exhaustive test. It is merely a restatement of the obvious timing test. The Court dealt with the main gateway test, on which they spent virtually no time, with the rather vague formula that the expenditure 'must be incidental and relevant' to the end of producing assessable income and summed up in the equally unenlightening causal formula that 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.[1]

On the second limb, the Court stressed that 'in actual working it can add but little'[2] to the first limb. It did give statutory recognition to the fact that

95 In fact the appeal dealt with two companies, but we shall ignore the second.
96 (1949) 78 C.L.R. 47, 57.
97 s. 23(q).
98 (1949) 78 C.L.R. 47, 58.
99 *Ibid.* 56-7.
1 *Ibid.* 57.
2 *Ibid.* 56.

expenditure was not to be disallowed merely because it did not produce income in the same accounting period. The second limb would be directed primarily to expenditures incurred before a business had produced income or to authorize the deduction of losses made in a 'distinct business'. The Court never really brought the second limb to bear on the problem. It looked at the width of the first limb, stressed the uncertainties about whether income would ever be produced and then invoked the capital characterization. It was said:

> So many contingencies make it impossible to say that it was a purpose of gaining assessable income that would be exempt.[3]

The companies in losing their mines lost a capital asset and it was this they were trying to re-establish.[4] The second limb they said perhaps

> should not be understood to refer 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.[5]

Much of the more vague general *dicta* about the functions of the first and second limbs, often cited in cases dealing with the central gateway test, must be read in the context of the problems considered, and remembering that our concepts on s. 51 have sharpened considerably since 1949. In particular, the discussion which asserts that to come within the first limb 'it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of assessable income'[6] occurs in the context of facts and directly after a discussion of temporal questions.

Expenditure properly incurred in one year, even if income is not produced in the same year, is now, and should properly be, deductible. But there are two closely related problems. First, if $100 is paid out in 1990 to earn $150 in 1995, the deduction will be in 1990 dollars and the assessable income in 1995 dollars. It can be seen that this arrangement could easily be structured to produce a tax subsidy. Second, and more serious, it is an open invitation to create more artificial tax avoidance schemes. The legislature attempts to deal with the more blatant examples of this scheme in s. 82KK but tax avoiders have already been successful in new devices based on the same principles and the chess game is well advanced. The problem should be solved by intelligent elaboration of s. 51.

A soft core scheme, and therefore one which is difficult to deal with, arose in the recent Federal Court decision in *Raymor (N.S.W.) Pty Ltd v. Federal Commissioner of Taxation*.[7] The scheme involved the pre-payment of trading stock in one lump sum. By negotiating an extra discount for the trading stock and accelerating its tax deduction, the taxpayer was doubly blessed. Lockhart J. upheld the accelerated deduction. The payment was for trading stock and, notwithstanding the tax advantage, was made in the ordinary course of business. The payments were incidental and relevant to the earning of assessable income. There was thus no basis for interference with the normal deductibility. In

[3] *Ibid.* 57.
[4] *Ibid.* 58.
[5] *Ibid.* 56.
[6] *Ibid.* 57
[7] 89 A.T.C. 5173.

particular, Lockhart J. cited *John v. Federal Commissioner of Taxation*[8] as authority for the proposition that the relevance of the existence of the purpose of gaining a tax advantage 'must now be doubted'.[9]

This reasoning shows the unfortunate directions in which inadequate analysis of the so-called fiscal nullity doctrine is leading the law. How can the ultimate purpose be anything but relevant for the purposes of s. 51? The section requires that expenditure be incurred to earn assessable income. Such a test cannot be satisfied by the formal nexus between an expenditure and the production of assessable income any more than it can be by a legalistic test which would grant the deduction of $1 million because it was spent for a pen used in earning assessable income. As previous analysis has demonstrated, the reasons for the expenditure must be based on a characterization looking at the widest context in deciding whether it was really spent to earn assessable income. Such an analysis would clearly include timing advantages. Now it may be argued that since the Act is based on historical accounting that such a timing advantage would not be sufficient to re-characterize the expenditure unless it was clearly stamped as part of a tax avoidance scheme, but it undermines the clear legislative objects of s. 51 to use the loose language of *John* as the basis for an assertion that the wider context and indirect purposes of the scheme are irrelevant.

*Capital Exception*

Expenditures which can be characterized 'capital' or 'of a capital nature' are expressly stated to be not deductible under s. 51. The nature of the characterization exercise was well put by Lord Denning in *Heather v. P.E. Consulting Group Ltd*:

> The difficulty [in the capital-income characterization] arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other; but this is simply not possible. Some cases lie on the border between the two; and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in the marginal cases; and then everyone is in doubt. Each can come down either way. When these marginal cases arise, then the practitioners be they accountants or lawyers must of necessity put them into one category or the other; and then, by custom or by law, by practice or by precept, the border is staked out with more certainty. In this area, at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find.[10]

Of course such a search for analogy without any conspicuous search for principle or policy to guide decision-making can lead to a body of law which evolves in a way which is increasingly out of touch with the economic or other policy issues which should guide intelligent decision-makers. But the first step to intelligent analysis is to assimilate Lord Denning's words of wisdom and to stop indulging in a pseudo-scientific quest for excessive precision. What we are after is *clarity* of analysis, not a mechanical test. To search for precision in such

[8] 89 A.T.C. 4101.
[9] 89 A.T.C. 5179.
[10] [1973] 1 All E.R. 8, 12.

a nebulous and politico-economic concept like 'income' is dangerous self-delusion.

The basic question then is whether expenditure is *more* correctly seen as expenditure to buy the cherry orchard or the cherries. The cherry trees are capital, the cherries are income. Believe it or not, there is a case on this very point.[11] Even in this simple case there were problems. The purchase of the orchard included that year's cherry crop. The taxpayer was held to buy the entire cherry orchard, not the cherry crop separately.

Unfortunately the real world is even more complex. Taxpayers make expenditures to buy, not cherry orchards which produce cherries, but tree farms which produce annual crops of Christmas trees. They make expenditures on research for patents which produce not only better returns from a production process but also new patents which themselves can be licensed or sold. They make expenditures to create intangible and diffused advantages from know-how or broader commercial advantages which are both the tree and the fruit of the business, increasing both its capital value in the market and its stock of expertise which it can exploit directly. The real world thus produces complex problems and the need for more difficult distinctions.

The nub of the distinction between capital and income as laid down by Dixon J. in the *Sun Newspapers Ltd and Associated Newspapers Ltd v. Federal Commissioner of Taxation*[12] and in the United Kingdom decisions, like *British Insulated & Helsby Cables Ltd v. Atherton*[13] is a choice between an expenditure:

— which brings into existence an enduring benefit to the business, or which adds to the business, which adds to the business structure, the entity, or its permanent (not necessarily perpetual) organization; or

— which is outlayed as part of the regular process of earning income, buying stock-in-trade, or operating the business.

*Capital Exception: Overlap with Timing Nexus*

On closer examination of the authorities we find that there is considerable overlap between the timing problems considered earlier and whether an expenditure can be characterized as capital. The two issues often arise in the same cases and there is not always a sharp demarcation in the reasoning on the two issues.

In the leading authority, *B.P. Australia Ltd v. Federal Commissioner of Taxation*,[14] the Privy Council had to consider whether expenditure incurred by an oil company to secure retail petroleum outlets was deductible. The Court considered the existing body of authority with great care but finally came down on a test which asked how closely the expenditure was tied to the assessable income which it produced. The test as the Privy Council presented it in *B.P.* distinguished between fixed and circulating capital:

[11] *Inland Revenue Commissioner v. Pilcher* [1949] 2 All E.R. 1097.
[12] (1938) 61 C.L.R. 337, 359.
[13] [1926] A.C. 205, 213.
[14] (1965) 112 C.L.R. 386.

> Fixed capital is *prima facie* that on which you look to get a return by your trading operations. Circulating capital is that which comes back in your trading operations.[15]

The expenditures in *B.P.* were lump sums paid to individual retail petrol outlets to secure a monopoly on sales outlets. They secured contractual rights which were taken to be five years (although odd ones were longer). The Privy Council found them to be circulating capital on the basis that the expenditures 'were sums which had to come back penny by penny with every order during the period'.[16] Obviously, the same money did not come back, so their Lordships obviously meant that there had to be a sufficiently close connection between the expenditure and assessable income. Time, of course, would be dominant among these nexus factors. The Privy Council used the framework of Dixon J. in *Sun Newspapers Ltd and Associated Newspapers v. Federal Commissioner of Taxation*,[17] but the heads tended to overlap and it fastened on a 'commonsense appreciation of all the guiding features'[18] which was 'derived from many aspects of the whole set of circumstances'.[19]

But it is clear that the Court refined the earlier authorities, which distinguished between expenditures 'creating acquiring or enlarging the permanent (which does not mean perpetual) structure',[20] and those incurred in 'earning that income itself'[21] and developed as its main framework the more general fixed circulating capital test. The factors considered in detail were the length of the ties and the nature of the right the taxpayer obtained as a result of the expenditure. Surprisingly, the fact that the method of payment was by lump sum, it was held, 'does not point very clearly in either direction',[22] rather than being a factor to be put on the fixed capital side of the balance. To repeat, the dominant framework was one which decided the critical fixed circulating capital characterization on the basis primarily of the timing nexus between the expenditure and the assessable income it produces.

If we look at the earlier authorities, we find that the timing nexus test and the capital income test form two parallel streams of authority dealing with very similar problems. In *Federal Commissioner of Taxation v. Snowden & Willson Pty Ltd*[23] the taxpayer company claimed a deduction for an expenditure of £4,252 spent on protecting its business reputation against parliamentary allegations of malpractice. The company were builders who sold their own houses in Western Australia. There were allegations in State Parliament that they had charged exorbitant amounts under their housing contracts by unfairly charging for extras and manipulating 'rise' clauses (which authorized increased contract prices in certain circumstances). The company spent over £4,000 defending themselves in press advertising and before a subsequent Royal Commission.

15 *Ibid.* 398.
16 *Ibid.*
17 (1938) 61 C.L.R. 337.
18 (1965) 112 C.L.R. 386, 397.
19 *Ibid.*
20 *Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd* [1964] A.C. 948, 960 *per* Viscount Radcliffe.
21 *Ibid.*
22 (1965) 112 C.L.R. 386, 405-6.
23 (1958) 99 C.L.R. 431.

The High Court held the expenditures were deductible. Fullagar J., delivering a judgment in which Dixon C.J., Williams and Taylor JJ. concurred, specifically held that the expenditure was not capital on the ground that, though the adverse publicity would affect goodwill, the 'allegations were made in specific cases, and were capable of directly affecting the past, present and future revenue of the company as such'.[24] If one thinks about it, this argument is a touch ungainly. Fullagar J. had to argue that the damage to reputation was serious enough in its impact on future income to be properly incurred for that purpose but not serious enough to threaten the Company's basic structure. Of course, his emphasis is on the word 'direct' and the fact that if the allegations were upheld, cash recently paid by customers might need to be refunded.

Dixon C.J. took up a similar theme when he emphasized that the proceedings were not necessarily directed at winding up the taxpayer company but at 'embarrassments in the present and future conduct of the business and, no doubt, a decline in its custom'.[25] Fullagar J. held that expenditure under the second limb extends to 'exigencies created by unusual or difficult circumstances'. He held that:

> The relation between the expenditure and the carrying out of the business is clear. The expenditure was incidental to the carrying on of the business. It was incurred in carrying on the business, and it was necessarily incurred because the exigencies of the business imperatively demanded that it should be incurred.[26]

Thus Fullagar J. was emphasizing the factor that this was not so much money ventured for future profit as expenditure necessarily incurred in an ongoing business, with direct nexus to those ongoing activities.

### *Capital Exception:* Hallstroms *and* Sun Newspapers

The decision in *Hallstroms Pty Ltd v. Federal Commissioner of Taxation*[27] is notable mostly because it contains a dissent, in one of the finest judgments by Australia's finest lawyer, Dixon J. (as he then was). But it is also a nice fact situation. The taxpayer company manufactured refrigerators. One of its competitors held a patent which rendered old refrigerators obsolete, which gave it a considerable competitive advantage and put the taxpayer's future viability in question. The patent was about to expire and the taxpayer was determined to stop an extension (in which cause the taxpayer was ultimately successful). The taxpayer had already geared up to manufacture the new type of refrigerator and £6,000 was spent for legal costs in the fight. The significant point was that on successful blocking of the extension the taxpayer did not gain any property right or advantage which was not available to the rest of the world. But it did gain a considerable competitive advantage against its most serious rival.

By a bare majority of the High Court the expenditure was held deductible. The majority comprised Latham C.J., Starke and Williams JJ.; the minority

[24] *Ibid.* 446.
[25] *Ibid.* 437.
[26] *Ibid.* 444.
[27] (1946) 72 C.L.R. 634.

comprised Dixon and McTiernan JJ. Latham C.J. applied *Southern v. Borax Consolidated Ltd.*[28] He reasoned that the taxpayer did not add to its profit-yielding structure or acquire a new asset. The expenditure merely allowed the taxpayer to carry on the same business as it had in the past and to avoid a loss. It gained the same right, no more or less, as any other member of the public. In Canada similar reasoning was used to allow deductibility of expenditure incurred in defending an attack for infringement of a trade mark on the use of the words 'shredded wheat'.[29]

The dissent of Dixon J. developed the ideas which have become so influential and have evolved in the current *B.P.* test. This rather special reasoning deserves extensive quotation:

> [I]n reference to a question whether a payment belonged to capital or to revenue Lord Greene M.R. said in *Inland Revenue Commissioner v. British Salmson Aero Engines Ltd*[30] that there had been many cases where the matter of capital or income had been debated. 'There have been',he said, 'many cases that fall on the border line. Indeed in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons'. Other judges have been less explicit concerning the barrenness of the attempt to find reasons and instead have described the distinction as amounting to a question of fact . . . For myself, however, I am not prepared to concede that the distinction between an expenditure on account of revenue and an outgoing of a capital nature is so indefinite and uncertain as to remove the matter from the operation of reason and place it exclusively within that of chance or that the *discrimen* is so unascertainable that it must be placed in the category of an unformulated question of fact. The truth is that, in excluding as deductions losses and outgoings of capital or of a capital nature, the income tax law took for its purposes a very general conception of accountancy, perhaps of economics, and left the particular application to be worked out, a thing which it thus became the business of the courts of law to do. The courts have proceeded with the task without, it is true, any very conspicuous attempt at analysis, but rather in the traditional way of stating what positive factor or factors in each given case led to a decision assigning the expenditure to capital or to income as the case might be. It is one thing to say that the presence among the circumstances of a case of a particular factor places the case within a specific legal category. It is another thing to infer that the absence of the same factor from some other case necessarily places that case outside the category and gives it an opposite description. But towards that kind of fallacy human reasoning constantly tends, and the decisions upon matters of capital and income contain much reasoning that is quite human. My own opinions upon the question I have attempted to explain in *Sun Newspapers Ltd and Associated Newspapers Ltd v. Federal Commissioner of Taxation*[31] . . . it may be useful to recall the general consideration that the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business.[32]

Dixon J. then turned to the facts and did not see much significance in whether the taxpayer acquired a proprietary right for its own use. In some language which has recently been extended to the core of s. 51 itself he said:

> Once there is a clear appreciation of the actual place in the business of the company which the existence, expected termination and threatened extension of the patent took, then I think the difference between, on the one hand, gaining or preserving a freedom to use the invention as of common right and, on the other hand, acquiring the exclusive right of user, which the extended patent would have conferred ceases to be significant in deciding whether the expenditure belonged to capital or revenue . . . what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process. The fact that, on the defeat of the application of the patentee for an extension, it was open to others as well as the company to set up as manufacturers of refrigerators embodying the invention was, comparatively speaking, of little moment to the company. At worst it meant the risk of possible future competition with some additional manufacturer. What did matter was that the company

28 [1941] 1 K.B. 111.
29 *Minister of National Revenue v. Kellogg Co. of Canada Ltd* (1943) 1 D.L.R. 62.
30 [1938] 2 K.B. 482, 498.
31 (1938) 61 C.L.R. 337, 359-63.
32 *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 C.L.R. 634, 645-7.

> should be enabled to place its business on a fresh foundation, by turning over to the production of a refrigerator according to the invention, and thus compete with the proprietor of the expired or expiring patent. It was for that purpose that the expenditure was incurred. The obstacle which was finally removed by the defeat of the application to extend the patent was much more than a hindrance or difficulty in the operations carried on by means of the company's established plant and its selling and general business organization. It was an obstacle to readjustment affecting the company's plant, its product, its course of selling and its business organization.[33]

The attempt to cut through the pedantry and to look, in perspective, is an approach which carries through judgments like *Commissioner of Taxes (S.A.) v. Executor Trustee and Agency Co. of South Australia Ltd.*[34] If capital gains from an increase in goodwill go tax free, on a matching principle, expenditures to protect it should not be deductible. The problem arises because the demarcation between expenditures to protect goodwill and to protect actual revenue is so rubbery. After all, as any economist will tell you, the concept of goodwill, indeed of capital value itself, is nothing but the present value, with a suitable discount for postponed enjoyment, which the market puts on some advantage likely to produce income (or some other benefit) during future years.

The decision in *Sun Newspapers Pty Ltd v. Federal Commissioner of Taxation*[35] involved a situation not entirely dissimilar to *Hallstroms*. The taxpayer company, publishers of the Sun, paid out £86,500 to prevent the publication of a rival evening newspaper, the World. About 60 per cent of the money was payable by instalments of £365 a week. In exchange the taxpayer obtained an agreement from their rival not to publish papers for three years within 300 miles of Sydney and that they would keep control of the premises and machinery.

The expenditure was held not deductible. Dixon J. (the other members of the High Court, Latham C.J. and McTiernan J., wrote concurring judgments) held that it was a capital expenditure because it finally removed the competition, it was for practical purposes once-and-for-all (in the sense that recurrence was only a theoretical possibility if other competitors surfaced), and the changes would have a lasting character, an indefinite influence on the taxpayer's business. Thus it was held that it was made in 'strengthening and preserving the business organization or entity, the profit yielding' structure.[36] He stressed that the idea of the once-and-for-all, enduring or lasting character of the benefit depended on degree and comparison. After all, the judge is merely characterizing them in any imperfect decision-making process in a less than crystal-clear conceptual framework as *predominantly* enduring or *predominantly* recurrent, and this will inevitably impose problems on the borderline.

> [I]t is not a question of recurring every year or every accounting period; but the real test is between expenditure which is made to meet a continuous demand for expenditure, as opposed to an expenditure made once and for all . . .[37]

In making this characterization Dixon J. proposed his famous test. The real essence and genius of his approach is easy to lose in a mechanistic application. It must be put in context. Recurrence is not a test. The lasting character of an

[33] *Ibid.* 648-9.
[34] (1938) 63 C.L.R. 108.
[35] (1938) 61 C.L.R. 337.
[36] *Ibid.* 364.
[37] *Ibid.* 362.

advantage is not a decisive factor. The task is to make a broad characterization on the preponderance of indicia. To facilitate this characterization process he developed this test:

> There are, I think three matters to be considered,
> (a) the character of the advantage sought, and in this its lasting qualities may play a part,
> (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and
> (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.[38]

In *John Fairfax & Sons Pty Ltd v. Federal Commissioner of Taxation*[39] the taxpayer claimed £300 in defending a legal action. The taxpayer was involved in an elaborate takeover fight against another publisher of the Sun, Associated Newspapers, and to gain ascendency in the battle for newspaper supremacy in the Sydney market Consolidated Press Ltd (who published the Daily Telegraph) made an offer to buy 90 per cent of the Associated shares. Fairfax (publishers of the Sydney Morning Herald) were more shrewd, offering to 'merge' the two operations and dangling the carrot of independence to the Associated Board. In the event Fairfax won, but it had to resist a legal action seeking an injunction by shareholders of Associated.

The expenses were held not deductible. The deductions were rejected partly because the expenditure did not fall under the second limb and partly because it was capital. Fullagar J. said of this expenditure: 'if one looks at the substance of the matter, it would accord much more with reality' to describe the expenditure 'as incidental to the acquisition of a new asset'.[40] Dixon J. also relied on the ground that the expenditure was capital. Menzies J. preferred to rely on the second limb but did decide, *obiter*, that it was capital.

The decision in *Fairfax* also contains some reasoning on the scope of the second limb, but it is reasoning based on the assumption that the function of this limb was not much more than to break the tight timing nexus between an expenditure and production of income. For that reason, like *Ronpibon*, it must be treated cautiously if cited for more general propositions. Menzies J. said that the second limb covers cases where expenditure is made not to produce assessable income in that year but 'assessable income generally' and would cover cases 'where the business had not yet produced [assessable income] or had failed to produce assessable income'.[41] But these are classic areas for consideration under the capital/income tests and demonstrate the extensive overlap in the tests. Fullagar J. does not seem to add much light when he cites a textbook to say that the second limb is concerned with cases

> where in the carrying on of a business some abnormal event or situation leads to an expenditure which it is not desired to make but which is made for the purposes of the business generally and is reasonably regarded as unavoidable.[42]

38 *Ibid.* 363.
39 (1959) 101 C.L.R. 30.
40 *Ibid.* 42.
41 *Ibid.* 48.
42 *Ibid.* 40, from Hannan J., *Principles of Income Taxation* (1946) 291.

But he did at least make it clear that the second limb was wider than the first. This does no more, again, than contemplate a looser temporal nexus under the second limb without really purporting to get down to sorting deductible sheep from non-deductible goats. This obscurity has not prevented subsequent judges and writers from building elaborate castles of reasoning on this flimsy foundation (which would no doubt have amazed Fullagar J. himself).

*Expenditure to Protect Capital*

The *B.P.* test which looks at the nexus of an expenditure to the 'circulating capital' has now taken centre stage. This is largely due to the triumph of Dixon J. in *Sun Newspapers*, but there is an older test in *Southern v. Borax Consolidated Ltd*[43] which still lurks in the background. In *Snowden & Willson*,[44] Fullagar J. said it has not in Australia 'been treated as decisive' but nor was it 'irrelevant'.[45] The test contrasts expenditure merely to protect capital (which tends to point to deductibility) against expenditure which adds to capital (which tends to point against it). The test therefore contains a heavy bias toward economic conservatism. In *Fairfax* Dixon J. doubted that the *Borax* test applies in Australia and hinted that it might be wrong. Fullagar J. affirmed the *Borax* decision and distinguished it on the facts. Menzies J. was not entirely clear on the point, saying that the *Borax* test is not decisive or infallible (indicating that it is relevant) but doubted whether an expenditure otherwise within s. 51 would be excluded because it created a new asset or added to an existing asset. That might still leave it some room to operate and point to deductibility where expenditure is made (as in *Snowden & Willson*) merely to protect an existing advantage. In *Broken Hill Theatres Pty Ltd v. Federal Commissioner of Taxation*[46] the High Court threw doubt on the rule when it asserted that expenditure to protect the company's business was capital. In the old State income tax cases the rule was applied.[47] In (1984) 27 C.T.R.B. (N.S.) Case 65 the Board of Review held that expenses incurred by a milk marketing authority to oppose an application by another person for a milk delivery licence was capital.

In a more recent United Kingdom authority, *Knight (H.M. Inspector of Taxes) v. Parry*,[48] a solicitor was refused deduction of the cost of defending, successfully as it turned out, allegations of personal misconduct because the expenditure was incurred to ensure that he could continue to carry on his professional practice and this was contrasted with expenditure incurred in carrying on the business.

[43] [1941] 1 K.B. 111. See also *Cooke v. Quick Shoe Repair Service* (unreported), listed in *Atkinson (H.M. Inspector of Taxes) v. Goodlass Wall & Lead Industries Ltd* (1950) 30 T.C. 447, 460.

[44] (1958) 99 C.L.R. 431.

[45] *Ibid.* 445.

[46] (1952) 85 C.L.R. 423.

[47] *Re Income Tax Acts No. 2* [1936] St.R.Qd 370; *Tooheys Ltd v. The Commissioner of Taxation for New South Wales* (1922) 22 S.R. (N.S.W.) 432.

[48] (1973) 48 T.C. 580.

*Capital-Income: Guidelines for Demarcation*

We are now in the position to draw guidelines from the authorities to decide whether an expenditure is capital and therefore not deductible under s. 51, always remembering that the demarcation is built on logical feet of clay and that it is constantly evolving and that it is a broad 'best choice of evils' type of decision. The dichotomy between capital and income is not so much a logically attractive line as a memorial to past political and economic compromises. At its very core it is difficult to sustain the demarcation in a principled way because the capital value of an asset or property right or mere commercial advantage in our capitalist system is nothing but the present value the market is willing to give to future advantages flowing from an asset. A shrewd adviser can always convert non-deductible capital expenditures into deductible revenue expenditures. To take one example from a great many, by borrowing a high percentage of the capital value of an asset the taxpayer incurs high interest charges (frequently exceeding the return on an asset). The interest charges (ostensibly spent to earn an income return on the asset) are thus deductible and the capital gain goes tax free. Thus a loss can be set against other income and, in effect, be converted into capital.

(1) The process of deciding whether an expenditure is capital or income is a broad characterization process based on all the circumstances.

(2) The basic criterion is whether the expenditure can be more appropriately characterized as made *predominantly* to bolster fixed capital (permanent income earning structure, perpetual advantage) or *predominantly* as part of circulating capital (to show a return directly in the form of income). After the inconclusive decision in *Cliffs International Inc v. Federal Commissioner of Taxation*,[49] this primary test must be juxtaposed with a test which looks primarily at the causal connection to the advantage produced.

(3) In making this characterization the following factors must be considered. No single factor can be relied on exclusively.

  (3.1) The 'lumpiness' of the payment (How often did it recur? Over what period? Did it extend over the life of the advantage?).

  (3.2) Is it likely, as a practical prediction, to recur in the future? As a broad approximation is it less misleading to say it was made 'once-and-for-all' or as a recurrent obligation?[50]

  (3.3) How substantial was the payment when compared to the entire capital structure of the taxpayer?

  (3.4) Did the advantage produced have a comparatively short life or was it, relatively speaking and for practical purposes, for the enduring benefit of the income-earning structure (say more than five years, at least)? If the expenditure was incurred to gain or create a fixed asset did it rapidly depreciate or waste?[51] If the expenditure was spent to produce a thing in action did it have a solid proprietary nature to it?[52]

[49] (1979) 9 A.T.R. 507.
[50] *Vallambrosa Rubber Co. Ltd v. Farmer* [1910] S.C. 519, 525 (H.L.).
[51] *British Insulated & Helsby Cables Ltd v. Atherton* [1926] A.C. 205, 213.
[52] As did the leases in *Regent Oil Co. v. Strick (Inspector of Taxes)* [1966] A.C. 295.

(3.5) How closely was the payment tied, on a plane of time, to the assessable income coming in dollar by dollar?

(3.6) Did the return from the expenditure vary with the profits produced by the advantage purchased? If it does this points strongly towards the income end of the spectrum.

(3.7) Did the expenditure produce a new income-earning potential or was it related more closely to the protection or enhancement of existing income-earning potential?

(3.8) Under the contractual arrangements, did the payment purport to pay for an item which was treated as a capital item of the business? Note that the absence of such an item is by no means conclusive, but it can certainly act against the taxpayer.

(3.9) Is the expenditure likely to be deductible in later years (*e.g.* as depreciation) and, if so, at which point of time is the deduction more likely to produce a fair reflex of income in each of the tax years?

(4) Under s. 51(2) expenditure spent on trading stock 'shall be deemed not to be an outgoing of capital'. On the face of it, this provision adds nothing because trading stock is circulating capital and expenditures on it would be deductible in any event. What the provision does is to mobilize this term of art, 'trading stock', and to use this as the basis of the test. It might also be relevant where the taxpayer acquired a large stock of trading stock for the future.

(5) The recent decision in *Brajkovich v. Federal Commissioner of Taxation*[53] showed that, notwithstanding the dramatic winding back of the relevance of the continuing business test in *Federal Commissioner of Taxation v. Myer Emporium Ltd*,[54] the business requirement is still necessary where the issue is whether the expenditure is part of a hobby, gambling, or an expenditure which is properly deductible. The rationale is that expenditure in furtherance of personal entertainment should not be taken into account in calculating tax.

[53] 89 A.T.C. 5227.
[54] (1987) 163 C.L.R. 199.