Before the High Court

The Treatment of Demolition Expenses under the Income Tax: the *Mount Isa Mines* Case

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If there is a Parkinson's law for income tax, it would go something like this: simple problems always generate difficult answers. Cooper's corollary to the supposed law reads: to be sure of reaching the wrong answer, start with the wrong question. Despite the feebleness of the humour, these propositions set up nicely the potential difficulty facing the High Court in *Mount Isa Mines Limited v FCT*.[1] The case raises a simple problem with no simple answer and, while some answer must ultimately be produced, the Court's decision will probably not answer all the issues raised by the case.[2] To be more precise, the Court will answer the question, are demolition expenses deductible from current income? The purpose of this note is to suggest that a better way of framing the questions might be: from which income should demolition expenses be deductible and when?

The discussion of these questions will proceed in a series of stages. The first parts of the paper will elaborate the model for the recognition and treatment of deductions under an income tax and then expand upon some examples where the model is both applied and departed from in current tax law. The paper will then discuss how the model would apply to the specific problem of demolition expenses. Finally, I will look at whether the current rules are capable of reaching the result suggested by the model, highlighting some questions that the High Court will need to answer in that process, and how the capital gains tax will change that result.[3]

(a) Two Questions in the Theory of an Income Tax

My reason for suggesting that the issues in the case concern timing and allocation stems from very fundamental principles about the way Australia's income tax system is intended to operate. It lies in the choice of income as the

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1 *FCT v Mount Isa Mines Limited* (1990) 90 ATC 4267 (Federal Court, decision of Northrop J); (1991) 91 ATC 4154 (Full Federal Court, decision of Sheppard, Pincus & Ryan JJ); leave to appeal to the High Court granted 7 June 1991.

2 The issue on which leave to appeal has been granted is whether the costs of demolishing certain structures is allowable as a deduction to a mining company. Leave to appeal was confined to the operation of s51(1) precluding potential arguments that might be raised under Division 10. All future references to legislation are, unless otherwise indicated, to *Income Tax Assessment Act* 1936.

3 I should add, by way of confession and avoidance, that the analysis presented here will concentrate upon themes and ideas the statements of law are presented in very general terms usually unsupported by detailed reference to authority. I am sure it would prove very easy to criticise the precision with which rules are expressed, but for the most part, it would also be largely unimportant to the arguments presented.

tax base; the particular formulation of income adopted in Australia; the reasons for granting and denying deductions; and the time at which deductions should be recognised. An understanding of these choices ought to underpin any decision made by the Court in the interpretation of the *Income Tax Assessment Act* if the operation of the Act is to be directed by principle rather than erratic meandering.

The theory of an income tax under the Haig-Simons tradition[4] requires that tax be paid on net gains realised by a taxpayer during a tax accounting period.[5] The reason for insisting on reducing gross receipts to net gains is straightforward — gross receipts are less likely to be an accurate indication of the ultimate increase in the taxpayer's net wealth during the period and hence the taxpayer's ability to pay tax will be overstated unless costs are recognised. So, some of the taxpayer's expenses ought to be subtracted from gross amounts in order to derive the taxpayer's true income.

But this subtraction is qualified — not all expenses are a reduction of the tax base. In fact, there are three circumstances where expenditures should not be recognised as subtractions from income: consumption expenditures; where public and government policy dictates; and where a quarantining rule operates to circumscribe a deficiency in the tax base. By definition, consumption expenses are part of the income tax base, not a reduction of it, and so consumption expenses are not deducted from gross receipts in calculating the amount of income that will be subject to tax. Of course, this simple proposition raises difficult characterisation questions which are given to the courts to resolve. This characterisation of an expenses as either personal consumption or dis-saving is not self-evident and the formal expression of this proposition as a legal rule in s51(1) is, on the most charitable view of the drafting, less than helpful.[6]

4 The use of this term springs from the work of Robert Haig as elaborated by Henry Simons. Haig's definition of income as the money value of the net accretion to economic power between two points of time was later elaborated by Simons as the concept of personal income — the sum of the value of consumption plus net accretion to savings during a period. See Haig, R M, "The Concept of Income" in Haig, R M (ed), *The Federal Income Tax* (1921); Simons, H C, *Personal Income Taxation* (1938). For a general discussion of the Haig-Simons tradition, see Groves, H M, *Tax Philosophers* (1974) chapter 8. It is clear that the Australian Treasury regards this particular version of the definition of income and the Haig-Simons tradition generally as the model adopted by the Australian income tax system. See *Australia, Tax Expenditures Statement 1990* (1990) at 48-50.

5 In this tradition, income is defined as the sum of personal consumption (C) and accretions to wealth (S) realised by the taxpaying entity ($_t$) during the period ($_p$). See Simons, above n4. In formal terms, the equation can be expressed as: $I_{tp} = C_{tp} + (S_{tp+1} - S_{tp})$.

See generally, McIntyre, M, "Implications of US Tax Reform for Distributive Justice" (1988) 5 *Australian Tax Forum* 219 at 234-46.

6 The formal rule — the expense a "loss or outgoing incurred in gaining or producing assessable income" (s51(1)) expresses a connection test which almost any outlay could conceivably satisfy and it has been left to the courts to circumscribe the potential leakage of the tax base with a variety of verbal formulae of limited descriptive and predictive power, such as finding the "essential character" of an expense, or whether it is "incidental and relevant" to earning income. It is understandable that at the periphery, hard choices have to be made and inconsistent or arbitrary rules will appear, but, in spite of the vagueness of the expression, the core of the idea is clear — personal consumption is an application of income, not a cost of income.

This was the underlying real issue at stake in a variety cases such as *Lodge* (1972) 46 ALJR 75 (costs of child minding); *Finn* (1961) 106 CLR 60 (costs of self education); *Lunney* (1958) 100 CLR 478 (costs of transport to work). In most cases, Parliament has not

The Haig-Simons system requires only this exclusion of deductions for consumption expenses, but Courts are obliged to take notice of other reasons for not recognising expenses. Governments often depart from the Haig-Simons model where some principle of public policy or some particular government policy dictates.[7] The final qualification on the ability of a taxpayer to deduct an expense arises because we operate in a world of second best. Where the tax base is not comprehensive, a deduction may be denied as a means of circumscribing the leakage in the tax base. This procedure is effected by a quarantining mechanism — the expense can only be set off against the income to which it is related. If that income is not taxed, the expense is never deducted.[8]

In summary, then, expenses should be deducted in calculating income unless they are consumption expenditure, or either of the policy or quarantining exceptions apply. These should be the only reasons for not recognising and subtracting any expense in an income tax which has a comprehensive tax base. In other words, there is no justification for "nothings" — expenses which are not consumption expenses or within the identified exceptions but which, nevertheless, are not treated as subtractions from gain.[9] This problem of "nothings" in an income tax with a

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intervened to overturn the decisions reached by the courts but has on occasions tinkered with the results. For example, the High Court decided in *Finn* that costs of self education were not personal consumption but Parliament limited the deduction by creating a threshhold of $250 before the expense can be claimed. See s82A. Similarly, the High Court held in *Lodge* that child minding expenses were personal consumption but Parliament decided not to treat them as personal consumption (that is, Parliament decided not to include payments for child care in the tax base) when the child care is provided through an employer to employees. See *Fringe Benefits Tax Assessment Act* 1986 s47.

7 For example, the non-deductibility of expenditure on entertainment (s51AE), the limits on depreciation of luxury motor vehicles (s57AF), and the non-deductibility of payments for fines (s51(4)) express government policies about the appropriateness and extent of providing government support for personal consumption and public policies about maintaining the deterrent effect of government sanctions. Similarly, the tax deductions for expenditure in the Australian film industry (Div 10BA of Part III), research and development (s73B), or primary production, give effect to government policies encouraging certain desired activities. The concessions offered to primary producers are legion. They include special concessional deductions for the cost of telephone lines (s70), water conservation (s75B), preventing land degradation (s75D), concessional valuation rules for livestock and access to income averaging and income equalisation deposit schemes (ss157, 159GC). Hundreds more examples of economic incentives and disincentives delivered through the tax system, are documented annually by Treasury. See Australia, *Tax Expenditures Statement* (1990).

8 The exclusion of deductions for capital expenditures in a system where capital gains were not taxed, as was the case in Australia prior to 1985 (with the trivial exceptions of s26(a) and s26AAA), operated to minimise the subsidy given to capital gain. The non-deductibility of capital costs ensured that the tax base was not reduced by capital expenditures, on the assumption that a capital expenditure was one that generated untaxed capital gains. It should be noted that this interpretation of a capital expense as one which generates a capital gain is not universally accepted as an accurate reflection of the characterisation rule actually adopted by the Courts. See Parsons, R W, *Income Taxation in Australia* (1985) ch7. Nevertheless, I believe it expresses a reason for quarantining rules in general, of which this was one. A similar rule still remains in the denial of deductions for costs incurred to derive exempt income — since exempt income is not within the tax base, expenses incurred to derive it are excluded from recognition.

9 For a discussion of nothings in the context of expenditure on environmental protection, see Cooper, G S, "The Treatment of Expenditure on Environmental Protection Under the Income Tax: A Note on the Operational Distortion of Nothings" (1991) 8 *Australian Tax*

comprehensive income base was one of the issues addressed by the Carter Commission of Canada. The Commission's *Final Report* noted:

> Our affirmation of the general principle that all realised revenues of a business should be brought into income carries with it the further principle, to which we subscribe that, all reasonable business expenditures should be deductible at some time. ...
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> Under the comprehensive income tax base all expenditures would be allowable at some time so that the problem would then become one of timing. Accordingly, we recommend that all expenditures that would be deductible under our test should be taken into account when incurred, unless they result in the acquisition of an asset which either falls within the definition of a specific capital cost allowance class [ie, depreciation], or is an asset, such as land or securities, which is not ordinarily expected to depreciate in value and the cost of which would be taken into account in computing the gain or loss when the asset was disposed of ... Much of the present uncertainty would disappear, and the term 'nothings' would become obsolete.[10]

The Carter Commission saw that the only issue in the treatment of non-consumption expenses under a comprehensive income tax should simply be one of timing.

It follows again from the Haig-Simons model, that income and deductions have to be allocated to discrete periods. The need to make this allocation leads to another simple rule derived from financial accounting: the time at which the expenditure was incurred is irrelevant; for the purpose of calculating taxable gain, the expenditure should be subtracted in the periods to which it is related.[11] This simple proposition means that non-consumption

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Forum 135.

10 Canada, *Report of the Royal Commission on Taxation* (Carter Commission) (1966) vol 4, pp227, 229-30.

11 This statement obviously begs two important question — why relate the expenditure to income, and how is an expenditure to be related to any particular period?

If an expense has to be allocated to some period this could be done in one of two ways: it could be allocated to some period appropriate to the deduction or it could be allocated to some period appropriate to the income to which the expense relates. Financial accounting has chosen the latter procedure — referred to as "matching" — for the eminently sensible reason that, where the income of the firm must be measured over discrete and arbitrary periods, matching is more likely to give an accurate estimate of the firm's true gain than simply subtracting expenses at the time money or assets pass from the firm. That reasoning is equally applicable to the Haig-Simons ideal: net income has been chosen as the best indicator of gain and the tax system is more likely to arrive at an accurate assessment of gain if expenses are attributed to the income which they produce than simply subtracted when money passes out of the hands of the payer.

In answering the second question, it is clear that a variety of possible relationships could be posited. For example if the expenditure procures an asset which is used to produce income over a period, the answer to the first question suggests that it is inappropriate simply to subtract the expense from the current period — the taxpayer has simply converted cash into a machine and may have suffered no real diminution in its wealth. Hence, the expense of the machine should be deferred but there are several ways of achieving this: the expense of the asset might be subtracted proportionately over the period during which the asset is used; it might be subtracted proportionately over the expected life of the asset (which may not be the same thing); it might be subtracted according to some assessment of the decline in value of the asset during each period; it might be subtracted according to some assessment of the actual income produced by the asset and so on. Not surprisingly, financial accounting adopts relatively certain measures such as the assumed life of the asset rather than more conjectural measures such as decline in value or income produced. See generally expenses which do not relate to periods beyond the current period should be subtracted immediately from income. But it also means that expenses which relate to more than the current period should be subtracted in each relevant period: where a present payment is related to income in future years, part of it should be deferred and pro-rated over all relevant years. Similarly, where a future expense will arise it should be advanced and subtracted from income in all the periods to which it relates even though the expense will be paid only in a future period.

But, again, expediency and administrative convenience often require second best solutions which modify the pristine clarity of the model. One exception to this rule arises where an expenditure generates income over more than one period but the income will not be taxed in each of those periods. In this case, a surrogate rule is adopted and all of the expenditure is thrown into that one year as well. So where the capital gain on an asset, although occurring over the extended period of ownership, is not taxed until the asset is sold, so also some of the cost of the asset is not subtracted over the period of ownership but only in the period when the asset is sold and any gain recognised and taxed. This procedure is simply an application of the quarantining mechanism discussed above in the context of deficiencies in the definition of the base. Here, the deficiency is a timing rather than a base definition problem, arising out of the inability to tax capital gain on an accrual basis. The solution is the same: quarantine the expense against the related income, and into the period in which that income is taxed.

I have spent some time elaborating the model for recognising expenses because it provides the principles which the income tax is trying to express, albeit imperfectly. Examples of the model in present tax laws are legion: expenses which procure no lasting benefit for the firm are often treated as immediately allowable deductions under s51(1);[12] where current expenses contribute to income earning over more than one period, they are often spread forward over the ensuing periods;[13] in some cases, expenditures which

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Hendriksen, E S, *Accounting Theory* (4th edn, 1982), p198.

The income tax also adopts (albeit with substantial modifications) the processes of financial accounting and uses the assumed effective life of the asset as the measure of depreciation. See Commissioner of Taxation, *Depreciation* (1991).

12 One determinant of capital expenditure is said to be that it produces an "enduring benefit" to the taxpayer. For example, the classic statement of Viscount Cave in *Atherton v British Insulated and Helsby Cables Ltd* [1926] AC 205 at 213, adopts the test: "When an expenditure is made not only once for all, but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, I think there is very good reason ... for treating such an expenditure as properly attributable not to revenue but to capital."

Other tests such as the lack of recurrence of a payment may be merely a surrogate for the enduring benefit test — payments which are frequent may be considered unlikely to procure an enduring benefit. While I am claiming support for my proposition from its negation, a procedure apt to generate logical fallacies, it seems to me, nevertheless, to be appropriate here. I must concede, however, that the Courts have not been consistent either in seeing the logic of the enduring benefit test or applying it consistently. This has led some commentators to conclude that the enduring benefit test does not accurately express the classification test used in Australia for discerning capital expenses. The reason is to be found in cases where the expenditure apparently produces no lasting benefit for the taxpayer, but the expense is still attributed to capital. See generally, Parsons, above n19, at pars 7.61-7.62. The failure of the Courts to adopt this test wholeheartedly need not mean that it is an incorrect test to apply.

13 Payments for plant, machinery, some intellectual property rights and some buildings which

generate benefits over an extended period but where the income generated by the expenditure will not be taxed until the disposal of an asset, are absorbed into the cost base of the asset and recovered only on sale.[14]

But while the Act contains these provisions, its operation is also subject to other judicial and statutory rules which qualify, modify and amend the ideal treatment of deductions: the Act omits rules which are needed to give comprehensive effect to the model;[15] and some timing rules are completely missing.[16] In particular, the quarantining rules have been poorly defined, never clearly identifying which expenses associated with capital receipts are to be quarantined against capital income.[17]

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procure lasting benefits and regular income over a period but which will waste over the period of use and are assumed unlikely to appreciate in value, are subtracted progressively over the effective life of the asset procured. The subtraction occurs under different regimes depending upon the type of asset procured: depreciation on "plant and articles" is allowed under s54 over their lives; depreciation on buildings constructed after 1985 is permitted under Div 10D over 40 years; the recovery of costs on units of industrial property is provided under Div 10B over the life of the property; the recovery of the cost of buildings used in the mining, oil or forestry industries occurs in Divisions 10, 10AA and 10A, generally over the life of the mine or field. Some otherwise allowable deductions which do not involve the purchase of assets within these regimes are similarly deferred by s82KZM.

14 Section 160ZH.

15 For example, the rules on occasions misstate the tax base. There is no rule permitting the recovery of preliminary expenses which do not result in the generation of assets, thereby overstating the ultimate income of a firm. A proposed amendment to the Act to permit deductions for expenses on environmental impact statements confirms this position — but for the amendment expenses incurred prior to commencing business are not allowable as deductions and if they do not result in the creation of assets cannot give rise to capital losses. See Taxation Laws Amendment Bill (No 3) 1991, clause 39. See generally, Cooper, above n9.

16 Clearly missing is a general regime which permits future payments to be deducted from current income, although a partial regime for the mining industry is now being considered. This omission is not a new problem. A suggestion in the report of the Asprey Committee in 1975 that special provisions be inserted into the Act to permit current year deductions for reserves to deal with mine site rehabilitation was acted upon only in 1990. Taxation Review Committee, *Final Report* (Asprey Committee) (1975) pars 19.31-19.35. The Prime Minister's statement on the opening of the CSIRO's Atmospheric Research Building on 19 March 1990 contains a promise to review the taxation arrangements as they apply to mine site rehabilitation and the removal of offshore petroleum platforms. This was confirmed in the 1990 Budget with the announcement of a deduction for mine site rehabilitation costs and removal of offshore drilling platforms. This was confirmed in the 1990 Budget with the announcement of a deduction for mine site rehabilitation costs and removal of offshore drilling platforms. See *Taxation Laws Amendment Act* (No 2) 1991. The announcement covers two specific circumstances: mine site rehabilitation costs and demolition costs of offshore oil platforms. It will not be applicable to demolition costs generally.

This omission means that income is incorrectly measured in the initial period and the period of payment. Indeed, much current tax jurisprudence and legislative effort is directed at preventing current deductions for anticipated costs until the costs are met thereby overstating income in the early years and understating income in the year of payment. See s51(3); Cooper, G S, "Tax Accounting for Deductions" (1988) 5 *Australian Tax Forum* 23 at 57-86.

17 In general terms, we have adopted the rule that if an asset produces any currently taxable income most of the acquisition, holding and disposal costs for the asset are deducted in full from current income. For example, costs of establishing a mortgage, some legal expenses, interest, rates, land tax and costs of discharging a mortgage are deductible in full from current income for income producing property. See ss51(1), 53, 67, 67A, 69. Some few, most importantly the price, will be quarantined against capital gain. Acquisition price, some legal costs, stamp duty, costs of defending title, costs of improvements are all quarantined against capital gain even for property used to produce assessable income. See ss51AAA,

(b) Applying the Theory — Analysing the Treatment of Demolition Expenses in a non-CGT World

I began with the observation that simple problems need not yield simple answers. The ideal treatment of demolition costs would yield no easy answer were I to attempt one, even using only the somewhat rarefied analysis presented so far, guided by theory and unconstrained by any concern for precedent. Some conclusions about the application of the model to demolition expenses *are* indisputable — the Haig-Simons model leaves no doubt but that in a comprehensive income tax, the taxpayer should be entitled to have demolition expenses recognised. They are clearly not consumption-type expenditures; no obvious principle of implicit public policy for denial of a tax allowance for the expenses occurs to me unless it depends upon the particular building concerned, and there is no express government policy against recognising these costs. Clearly in a system with a capital gains tax, these expenses should be recognised.

The area where there is room for dispute is the quarantining issue — both as to tax base and timing. In a tax system where capital income is excluded from the tax base, some capital costs will also be excluded from the tax base. Are demolition expenses in the excluded class? And this dispute will remain even after the capital gains tax (CGT) becomes fully operational because CGT generally solves only tax base issues, not timing issues. We know that in every tax system, capital gains are treated preferentially because they cannot feasibly be taxed on accrual.[18] Given this timing difficulty, should demolition expenses be allocated against capital income or should they be allocated against current income? Quarantining issues of either sort (either excluding expenses from the base altogether or allocating them to certain periods only) are an acknowledgement that once the first-best solution is not possible, to argue that one approach is the only correct treatment is unconvincing. But this difficulty ought not lead to apathy or despair — the High Court can choose, if it wishes, to express rules which emulate the model and are guided by the same principles which underlie it. The Court can try to approximate the model or ignore it.

The process which will occur before the Court is unlikely to approach the problem in a way which tries to express the principles of the Haig-Simons model underlying the existing tax rules. The argument will instead focus on the usual problems of attempting to apply the vague and unhelpful tests of s51(1): whether the expense was "incurred in gaining or producing assessable

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51(1), 160ZH. None will be apportioned between income and capital gain, although that was attempted in the mid-1980s. A quarantining mechanism which would have apportioned interest costs between current income and capital return for negatively-geared income producing property was attempted but later repealed to encourage investment in tenanted residential accommodation after a sharp decline in the real estate market. These former negative gearing rules, contained in ss82KZC-82KZG, limited deductions for interest costs to the amount of rental property income and quarantined recognition of the excess costs to, and until, any capital gain was realised on sale of the rental property. See ss160ZA(1)-(3) (since repealed). Some, like non-asset start-up expenses, will be lost completely. A thorough application of quarantining rules might absorb more or different costs into an asset; see, for example, the inclusion in the cost base of some current expenses in Taxation Law Amendment Bill (No3) 1991, clause 64.

18 These difficulties can then often be exacerbated by introducing further distortions such as lower nominal rates for capital gains or inflation adjustments.

income" or "in carrying on a business for the purpose of gaining or producing assessable income" and the interpretation of the proviso prohibiting deductions for expenditures of capital or of a capital nature. A recitation here of the multitude of cases that could conceivably be cited would require the rest of this volume and is unlikely to be instructive. No doubt the High Court will reach a conclusion and attempt to anchor its reasoning in implications and nuances drawn from the copious dicta to which it will be referred. Few authorities seem to me to be especially apposite and the only prior High Court decision on this precise question, *FCT v Broken Hill Pty Co Ltd*,[19] treats the expenses as capital. The reasoning in BHP is straightforward, if to my mind, a trifle unorthodox — the demolition of structures, even though recurrent, created an enduring improvement to the taxpayer's ongoing business. The focus was not retrospective but prospective; the dominant theme was not one of demolition but rather of site improvement.

And no doubt the taxpayer will rely heavily upon the apparent trend toward broadening the income concept, displayed not least by the High Court, in recent appellate judgments. The taxpayer will argue that this broadening should be "bipartisan" applying equally to income and deductions. The corollary of *Cooling*, *Myer*, *GKN Kwikform*[20] and all the rest should be a deduction in this case, or so the argument will run. It will indeed be a nice irony if the Commissioner's successes in increasing the compass of the income definition leads to a corresponding broadening of the scope of deductions — the offsetting consequences of both will mean that the net revenue effect will be minimal but the cost in practitioner angst will be extreme. It will also continue the trend toward rendering the CGT largely redundant for business taxpayers, another of the ironies of recent tax reform.

If I were to hazard a guess, the Court may well reach its decision on a simple combined factual and legal conclusion: this asset in this taxpayer's business was a capital asset, and the treatment of demolition costs follows the nature of the asset demolished. Alternatively, if the prospective approach adopted by Kitto J in *Broken Hill* were applied, the decision might be: this expense effected such an insignificant change to the taxpayer's property that it is a minor modification not a capital improvement. Either conclusion seems plausible and would be unremarkable and, with respect, largely unhelpful. Neither approach answers the larger theoretical issues raised by the case. Those issues are: when does an expense take the nature of some proximate asset (or instead derive its character derive from the expenditure itself); and what should it mean to characterise an expense as "capital"?

(i) Characterisation: Dependent and Independent Approaches

The first conclusion hypothesized above implies that the characterisation of demolition expenses depends upon the character of the underlying asset demolished, rather than the independent nature of demolition expenses themselves. The second conclusion implies that it is the nature of the expense itself that governs. Is either the correct approach to characterisation problems?

19 (1969) 120 CLR 240.
20 90 ATC 4472, (1987) 163 CLR 199, 91 ATC 4336, respectively.

It is clear that Australian tax jurisprudence has no reasoned answer to this question. Consider a few examples. Interest which is a holding cost securing the use (through ownership) of some asset, is a deductible expense whether the asset procured is a capital or revenue asset of the taxpayer.[21] Similarly, rent which is a holding cost securing the use of an asset is likewise a deductible expense, again regardless of the nature of the asset used, so long as the asset is used to produce assessable income. Insurance premiums on business assets are deductible whether or not the asset insured is a capital asset. There is apparently something in the character of these expenses which makes them deductible whether or not they relate to capital or revenue assets. But consider the costs of defending title to an asset — the characterisation of this expense depends in part upon the nature of the asset under attack.[22] Or consider exchange gains and losses on currency used to pay for an asset — the characterisation of these costs and revenues apparently depends upon the nature of the asset being procured with the foreign funds.[23] Some costs must be subordinated to the character of the assets they create and others will be allowed to behave independently.

In many senses, this issue is the analogue of the problems of quarantining raised above. An expense which is quarantined against the income from an asset, is likely to be treated as a capital expense where the asset is a capital asset. Similarly, where the expense is one which is characterised independently of any related asset, it is presumably more likely that the expense will not be quarantined against income from the asset or of its type. One important contribution to tax jurisprudence which this case could offer would be some guidance on the circumstances when each approach is applicable. An answer would have important implications elsewhere.

(ii) The Capital/Income Dichotomy: Getting it Right

Whether or not the problem of classifying the expense is resolved, it would be desirable for the Court to explain the distinction between capital and revenue outgoings and what consequences follow from each characterisation. In the Panglossian best-of-all-possible-worlds, this issue carries no significance but in this second-best world, some indication from the Court of the meaning and consequence of the distinction would be helpful. I have argued elsewhere that the essence of the capital/income dichotomy is: does the outgoing contribute to the derivation of assessable income in more than one accounting period?[24] If yes, the expense is defined as "capital" with the consequence that it should be allotted and quarantined to that income and to the periods to which it contributes. If no, the expense is defined not to be capital and, provided that it otherwise meets the tests of the model described above, it should be deducted from income immediately. It must be conceded that this test may often be indecisive but at least it expresses a rule which can be administered and which approximates the theoretical model.

21 *Munro* (1926) 38 CLR 153. Instead, all that is required is that the taxpayer use the borrowed money to produce assessable income, usually by using it to procure an income producing asset.

22 *Broken Hill Theatres Pty Ltd* (1952) 85 CLR 423; *John Fairfax & Sons Pty Ltd* (1959) 101 CLR 30; *Snowden & Willson Pty Ltd* (1958) 99 CLR 431.

23 *Texas Co* (1940) 63 CLR 382; *Caltex* (1960) 106 CLR 205; *Avco* (1982) 56 ALJR 668.

24 Cooper, above n16.

Let me suggest how the Court might treat demolition expenses if it were to be guided by the types of principles to which the Haig-Simons model aspires. Assume that a dependent classification approach is correct and it is the character of the building that is significant. The building is a capital asset if it is used in the business for more than one year and, ideally all its costs, including the demolition cost, would be recovered over the life of the structure, commencing in the year of construction. But in this second-best world, the administrative difficulties with that solution are significant.[25] So, if administrative difficulties preclude a current deduction for provisions for demolition expenses, a second best solution is necessary: demolition costs should be allowed as deductions when incurred. This rule defers the deduction from the ideal it is true, but it does so consciously, and it tries to do so on a principled basis, not, for example, deferring the costs longer than is appropriate, nor omitting them from the tax base entirely.

Now assume that an independent approach is used and it is the character of the demolition cost which is relevant. The demolition cost does not of itself contribute to the derivation of income beyond the current period — it is pure cost in the current year — unless it serves to enhance the value of the land. If the demolition cost simply removes the dangerous structure, it should be allowed as an immediate deduction. If it adds to the value of the land, it might be added to the cost base of the land. Again, neither approach is theoretically ideal, since neither recognises the contribution of the structure to any prior income earning, but an explanation based upon either approach would at least recognise the issues involved, rather than relying upon irrelevant matters such as the size of the building, the number of dollars spent, whether they are paid in one instalment or several, the frequency of demolitions, and so on. Reasoning based upon these factors will obscure the principles which the rules ought to reflect.

(c) Demolition Expenses Post-CGT

Since all the relevant facts in *Mount Isa Mines* arose prior to 1985, CGT can have no application, but it is interesting to speculate how Part IIIA would operate in respect of demolition costs. This issue will not be rendered moot by the Court's decision since the income tax and CGT are not discrete systems. Future taxpayers will still have to consider the application of CGT to demolition costs whether or not the High Court concludes that demolition expenses are revenue in nature, although with a little foresight and some judicious *dicta* in a case like this, the High Court may be able to avert some of the major difficulties that, at least in my opinion, lie in wait in Part IIIA.

The general structure of Part IIIA imposes tax on profits arising from the disposal of assets. In general terms, the application of CGT depends upon the four elements in Part IIIA: finding an asset that was being disposed of;

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25 The estimation of costs which will not be met until later periods, if at all, raises obvious problems: the rate of inflation and its effect on costs; the likely state of technology; the effect of changing community concern and legislative dictates on demolition and preservation; the treatment of reserves which are not eventually expended; and so on. In addition to the administrative difficulties, there are significant legal barriers to such a procedure, but they do not constrain the High Court. See generally, Cooper, above n16; Cooper, G S, "Timing of Deductions". *Papers of 1990 Intensive Seminar* (NSW Division, Taxation Institute of Australia, 9 November 1990).

finding an event that amounted, actually or constructively, to a disposal; determining the consideration received or receivable in respect of the disposal; and calculating the amount of the taxpayer's cost base in the asset. Finally, since Part III and Part IIIA are designed as overlapping rather than discrete, it is necessary to integrate the result under CGT with the ordinary income tax. If the income tax system were working properly, the taxpayer who must destroy a capital asset would expect to recover the cost of the asset as a capital loss — by being able to set off the cost base against any consideration on its disposal — and the taxpayer would be able to recover the loss only once through either the income tax or CGT. The further cost represented by the demolition expenses would be either deducted from income or added to the cost base to increase the size of the capital loss. Let me repeat, this is the result that would occur if the entire income tax system operated correctly.

The first issue is to determine which "asset" was being disposed of. While the answer may seem obvious — it is the structure being demolished — a complication arises where land and buildings are concerned. Under property law, fixtures are part of land and s160P confirms this treatment: for CGT also, land and buildings are ordinarily to be treated as one asset.[26] But certain exceptions are stipulated. For the most part, the exceptions are to deal with transitional problems such as constructing new buildings on pre-CGT land,[27] or performing substantial renovations to structures on pre-CGT land[28] where the operation of CGT might be successfully deferred by substantially developing assets while preserving their pre-CGT status. But two other important exceptions are created. Section 160P(4) and (5) treats, for CGT purposes, structures on land as separate "assets" from the land on which they are erected where the "building ... is treated for the purposes of this Act other than [Part IIIA] as an asset separate from the land" or "an asset forming part of a building is treated [elsewhere] as an asset separate from the building".[29] While the drafting is less than felicitous, the section means at least that there are two potential candidates for the relevant CGT "asset" — either the structure alone, or the combined land and structure — and the apparent intention is that there are to be two assets where the building is within s54 or Division 10D. I will work with each hypothesis to encompass the treatment of the demolition costs of non-income producing buildings, where s160P(8) still treats the building as part of one asset being the land.

(i) Assumption 1: Structure is the CGT Asset

If the structure is the "asset", is demolition a disposal of the asset? This event, "disposal," is the realisation event which crystalises unrealised capital gains and losses into tax events. Section 160N provides that the "destruction of an asset constitutes a disposal of the asset" and "the destruction of part of an asset constitutes a disposal of that part." The word "destruction" is broad

26 Section 160P(8).
27 Section 160P(2).
28 Section 160P(7).
29 The reference to "treatment as an asset separate from ..." is curious. No such effect is ever specifically attributed by the Act but the intention of the drafter is reasonably clear — if the building or part of it is depreciable or subject to the capital cost recovery system in Division 10D, for example, then it is to be treated as its own asset for Part IIIA.

enough to encompass the demolition of the building, but another interpretation of the section might confine it to involuntary acts that are suffered by an asset rather than deliberate acts of demolition.[30] That interpretation would, however, be most inconvenient since the general definition of disposal in s160M requires, except in the case of certain intangibles,[31] "a change ... in the ownership of an asset" before there is a disposal. This phrase does not readily lend itself to an asset simply ceasing to exist.[32] So, if the deliberate demolition of an asset is within s160N, the structure is disposed of by its demolition. If demolition is not within s160N, there may simply be no CGT event on demolition of the structure.

The costs that enter the cost base of an asset are defined exhaustively in s160ZH. It is here that the taxpayer will confront the major difficulty. Under the hypothesis that the structure is the relevant asset for CGT, it is not obvious how the costs of demolishing it will fall within any of the terms of s160ZH. Demolition costs are clearly not acquisition costs, nor incidental to acquisition, nor costs of defending title to the structure.[33] The only relevant possibilities are that demolition costs are capital enhancement expenditures, or incidental costs of disposal. The inclusion of capital enhancement expenditures in the cost base of an asset is only available if the expense "was incurred for the purpose of enhancing the value of the asset and is reflected in the state or nature of the asset at the time of disposal of the asset." Presumably, demolition is not undertaken to enhance the value *of the structure* but rather to eliminate it. The other possibility, that demolition is a cost incidental to the disposal of the structure, is precluded by the definition of "incidental costs" which limits them to non-deductible professional fees, advertising and transfer costs.[34] Under this hypothesis, demolition costs may never enter the cost base of a capital asset.

The consideration in respect of the disposal of the asset would until recently have presented another problem. Section 160ZD(2) deems a taxpayer who receives no actual consideration on the disposal of an asset, to receive the market value of the asset at the time of its disposal, presumably as an anti-avoidance device to prevent thwarting the CGT by making gifts. Unfortunately it might have had the consequence in a case such as this, of generating some amount[35] as a deemed sale price when the taxpayer will actually suffer the total loss of the structure and at a cost.[36] This would add the

30 The reference in the concluding parts of the section to "whether or not any amount of money or other consideration by way of compensation or otherwise is received as a result of or in respect of the loss or destruction" tends confirm this view. It may also be confirmed by s160U(9) which deems the time of disposal to be the time at which compensation is received, the loss is "discovered" or the destruction "occurred".

31 See s160M(3).

32 The specific amplification of the definition of disposal by s160M(3) to include abandonment, lapsing and ceasing to exist confirms the view that the general test in s160M(1) does not easily incorporate demolition.

33 See ss160ZH(1)(a), (b), and (d).

34 See s160ZH(7), (8).

35 It is not inconsistent with a desire to demolish the building to suggest that it would have market value.

36 The analysis would be different if the asset was insured and the taxpayer were entitled to receive compensation on the destruction of the asset. That situation would also raise the possibility of a rollover of the cost base of the demolished asset into another replacement asset. See s160ZZK, 160ZZL.

insult of generating a fictitious sale price to the injury of not increasing total cost by demolition costs. The recent amendment to s160ZD(2A) will, it seems, now resolve this problem as the taxpayer is deemed to receive market value only when the disposal (for no consideration) also amounts to an acquisition of the asset by some other person. In the case of demolition, no such acquisition occurs but it needs to be stressed that this rectification is a relatively recent amendment.

Finally, there is the integration issue: will the taxpayer be able to claim both a deduction under s51(1) and a capital loss? There is no general rule in Part IIIA which says that an expense which is an allowable deduction cannot also enter the cost base of an asset. There are, instead, a variety of integrative mechanisms spread throughout Part IIIA.[37] In this case, the integration will work. Any amount included in the cost base of the asset by s160ZH(1)(c) is qualified by the requirement that it be "expenditure of a capital nature" thereby excluding amounts that have been allowed as deductions under s51(1).

(ii) Assumption 2: Land (with Structure) is the Asset

If the relevant asset is, instead, the combined land and structure, the entire analysis must be repeated. The demolition of the structure may be a part disposal of the combined asset triggering tax consequences at this stage or, if s160N is not applicable, there is now the possibility that the CGT consequences of the demolition expense will simply be delayed until disposal of the land.

Section 160ZI requires where there is disposal of part of an asset that the cost base of the unpartitioned asset be apportioned in a particular manner over the part disposed of and the part retained but there is a proviso that if particular expenses can be related exclusively to either part, they are to be allotted to that part. The cost of removing the defective structure ought, so it would seem, to be allotted to the cost base of the structure. This simply replicates the dilemma above — can the demolition of the structure be its improvement? If not, the demolition expense will be lost since, although attributed to the structure, there is no provision through which it can enter the structure's cost base. One solution would be to argue that removal of the structure is, in fact, an improvement to the land and its cost should be allotted entirely (or at least in part) to the land. This argument would bring the demolition cost within s160ZH(1)(c) as the value of the demolition work was incurred to enhance the value of the land and will (unless the land is re-developed) be reflected in the state or nature of the land when sold.

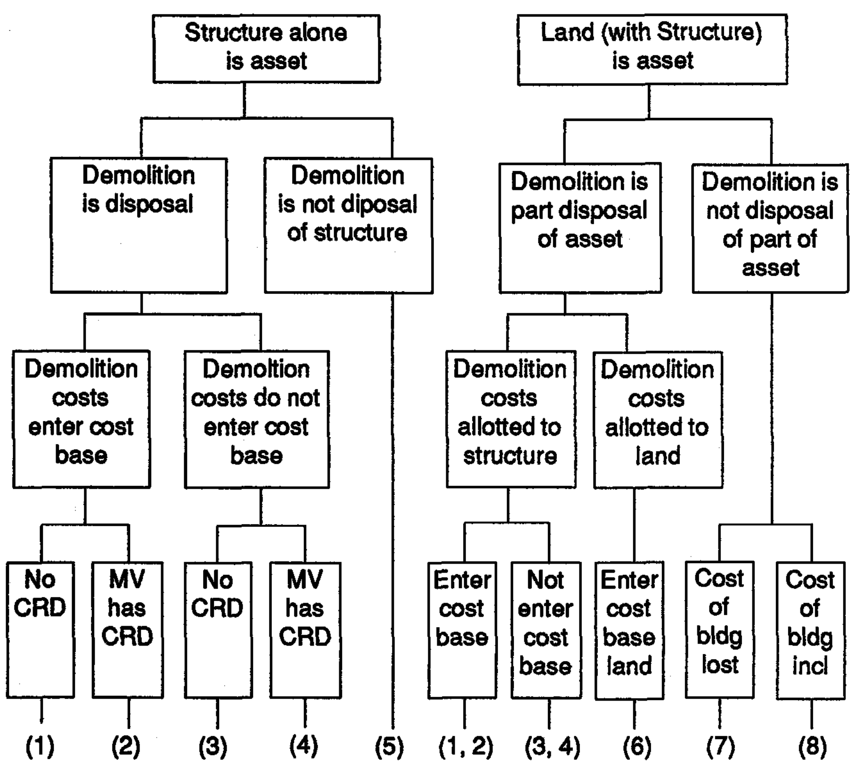
There are two final possibilities that arise if s160N does not apply, so that the demolition of the structure does not trigger any CGT consequences at that time. The CGT consequences are deferred until the time of disposal of the land, but at that time, the structure no longer exists. Two different results may follow depending upon when the structure was erected. If the structure were erected after acquisition of the land, its cost would, on the assumption that the land and structure are a single indivisible post-CGT asset, be added to the cost base of the land and subtracted from the eventual sale price. Unfortunately, however, the cost of the *building* will be lost through the very same problem discussed above — the building is no longer reflected in the nature of the

37 See, for example, ss160ZH(1)(c), 160ZH(6)(8), 160ZK, 51AAA. Similar integrative provisions for income receipts can be found in ss160A, 160L(3), 160ZA(4), 160ZA(5).

asset (being the land now minus building) that is sold. If the building had been used to produce assessable income during its life, that is not a substantial problem: the cost of the building will already have been recovered during its life through the depreciation regimes of s54 or Division 10D. If, however, the structure was not used to produce income, there is the possibility of losing the cost of the building altogether from both the income and CGT systems. In contrast, the demolition expenses will remain included in the cost base if they are attributed as improvement expenses of the land as just discussed. This result is entirely paradoxical: the cost of constructing the building may be lost but the cost of demolishing it is recognised. If, however, that taxpayers buys the land with the building already constructed on it, the cost of the building is recognised as part of the consideration for the acquisition of the land, rather than as an improvement cost,[38] and both the construction and demolition cost may be recognised.

The meticulous reader will have counted at least six different solutions suggested. An example may help clarify for the rest of us these divergent outcomes, how they come about and what they mean for a taxpayer's tax liability. Assume that a taxpayer buys land for $100 and constructs a building

Figure 1 Demolition Costs Under CGT



38 This is, the value of the building will be absorbed into the land and expressed as a cost of acquiring the land under s160ZH(1)(a) rather than as an improvement to the land under s160ZH(1)(c).

on it for $60. In Year 1, the taxpayer decides to demolish the building at a cost of $30. The building could be sold for its constituent elements (bricks, timber, tiles, etc) for $20 but the taxpayer decides to proceed with demolition rather than delay the process by deconstructing the building. In Year 2, the taxpayer sells the cleared land for $140. In theory, by the end of Year 2 the taxpayer should recognise a loss of $50 (total costs are $190 and total returns are $140, assuming the taxpayer is not to be taxed upon the potential income represented by the market value of the structure). To simplify the arithmetic, the indexation of costs for inflation is ignored. The potential tax consequences of these facts can be represented in the above diagram, the explanation for which is set out below.

Column	Explanation	Y1	Y2	Tot
(1)	Taxpayer increases cost base of structure (being its own asset or part of the prior asset by demolition costs (if not already deducted) and does not recognise deemed market value on demolition.	-90	40	-50
(2)	Taxpayer increases cost base of structure (as sole or part asset) by demolition costs but is forced to recognise deemed market value on demolition.	-70	40	-30
(3)	Taxpayer is not permitted to increase cost base of structure by demolition costs (and is forced to attribute demolition costs to the structure) and does not recognise deemed market value on demolition.	-60	40	-20
(4)	Taxpayer is not permitted to increase cost base of structure by demolition costs (and is forced to attribute demolition costs to the structure) and must recognise deemed market value on demolition.	-40	40	0
(5)	No CGT consequences on demolition of structure; does not enter cost of land.	0	40	40
(6)	The demolition costs are allotted to the land; taxpayer recovers cost base of structure on demolition.	-60	10	-50
(7)	No disposal in Year 1; demolition costs added to cost base of land; cost of building not recovered on sale of land	0	10	10
(8)	No disposal in Year 1; demolition costs added to base of land; cost of building survives destruction and added to cost of land	0	-50	-50

So much for statutory meandering and the certainty of tax law. I place no particular faith in any of the outcomes being "correct". Ultimately the amount that enters the CGT calculations depends upon which interpretation on each issue is accepted at various points in the process. I trust that this discursus into the uncharted realms of the income tax and CGT has convinced the sceptics that simple questions can indeed generate difficult answers. Whether the importance of the problem merits such a complex set of rules to resolve it, is another matter entirely.