TR 94/D9 - Income tax: how the High Court of Australia's decision in Fletcher's case applies to the question of when an outgoing is deductible as incurred in gaining or producing assessable income

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Draft Taxation Ruling

Income tax: how the High Court of Australia's decision in ***Fletcher's case*** applies to the question of when an outgoing is deductible as incurred in gaining or producing assessable income.

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What this Ruling is about

1. This Ruling considers how the decision of the Full High Court of Australia in *Fletcher & Ors v. FC of T* 91 ATC 4950; *Fletcher v. Federal Commissioner of Taxation (*1991) 22 ATR 613 applies in answering the question of whether outgoings will be deductible as incurred in gaining or producing assessable income where that expenditure may have been incurred for a variety of reasons or motives.

2. The High Court's judgment restates and explains the tests of deductibility for outgoings under subsection 51(1) of the *Income Tax Assessment Act 1936*, particularly in circumstances where outgoings exceed assessable income.

3. The question taken on appeal to the High Court was whether the taxpayers were entitled to deductions under the first limb of subsection 51(1) for all or part of the interest incurred on borrowings made on entering into an annuity scheme.

Ruling

4. Generally, for outgoings to be characterised as incurred in gaining or producing assessable income, it is not enough to say that the production of assessable income is the occasion of the outgoing or

that the outgoing is a cost of a step taken in the process of gaining or producing assessable income. There must be a genuine relationship between the whole of the expenditure and the production of such income for outgoings to be deductible.

5. If the expenditure produces an amount of assessable income greater than the amount of the outgoing, there would normally be no need to examine the taxpayer's subjective thought processes (i.e. motives and intentions) in characterising the expenditure as falling within the first limb of subsection 51(1).

6. If the outgoing produces no assessable income, or the amount of assessable income is less than the amount of the expenditure, it may be necessary to examine all the circumstances surrounding the expenditure. These may include the direct and indirect objects and advantages which the taxpayer sought in making the outgoing.

7. Where such an examination is necessary, it is a "commonsense" or "practical" weighing of the circumstances which will provide the answer as to whether all or part of the outgoing was incurred in gaining or producing assessable income and is deductible under subsection 51(1).

Date of effect

8. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

9. The first limb of subsection 51(1) provides that:

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

10. In analysing subsection 51(1) in *Fletcher,* the High Court made two preliminary points. The first was that the words 'to the extent to which' in the subsection make it clear that apportionment of outgoings is contemplated in at least two circumstances:

> 'One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services.
>
> The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently.' (per Latham CJ; Rich, Dixon, McTiernan and Webb JJ in *Ronpibon Tin N.L. and Tongkah Compound N.L. v. FC of T*(1949) 78 CLR 47 at 59).

The High Court pointed out that what represents the appropriate apportionment of such items of expenditure is essentially a question of fact in each case.

11. The second preliminary point made by the Court about subsection 51(1) is that the expression '*the* assessable income' does not only refer to assessable income derived in the particular income year but also to assessable income which the relevant outgoing 'would be expected to produce.' (*Ronpibon Tin* at 57).

12. The High Court affirmed that whether an outgoing is incurred in gaining or producing assessable income under the first limb of subsection 51(1) is a question of characterisation of the expenditure. It has been pointed out on many occasions that an outgoing will not properly be so characterised unless it is 'incidental and relevant to that end'. It has also been said that the test of deductibility under the first limb of subsection 51(1) is 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. '(*Ronpibon Tin at 57).*

13. This does not mean that the motive of the taxpayer is not a relevant factor in characterising an outgoing as deductible under the first limb of subsection 51(1). At least in a case where a taxpayer voluntarily incurs outgoings, his or her subjective views of what the expenditure was expected to accomplish might, depending on the circumstances of a particular case, be a decisive factor in characterising the expenditure as having been incurred in gaining or producing assessable income.

14. In a case where the outgoing gives rise to a larger amount of assessable income, this suffices, without more, to characterise the whole outgoing as one incurred in the production of assessable income. If the outgoing can be wholly so characterised...'it is not for the Court or the Commissioner to say how much a taxpayer ought to

spend in obtaining his income, but only how much he has spent.' (see *Ronpibon Tin* at 60; *Cecil Brothers Pty Ltd v. FC of T*(1964) 111 CLR 430 at 434).

15. In situations where no assessable income is derived as a result of a particular outgoing, or the relevant assessable income is less than the amount of the outgoing, the difference between the outgoing and the benefit of the income produced will need to be examined before the expenditure can be characterised as incurred in gaining or producing assessable income. The High Court said this examination would need to be by a process of :

> '...a weighing of the various aspects of the whole set of circumstances, including direct and indirect objects and advantages which the taxpayer sought in making the outgoing' (see e.g. *Robert G. Nall Ltd. v. FC of T*(1936- 1937) 57 C.L.R. 695 at 699-700,706,708-709,712-713).

16. This process encompasses a 'commonsense' or 'practical' weighing of all the relevant circumstances (see *BP Australia v. FC of T* [1966] AC 224 at 264; *Hallstroms Pty Ltd v. FC of T (1946) 72 CLR* 634 at 648).

17. If all the expenditure is characterised as genuinely incurred in gaining or producing assessable income when all the factors have been examined in a practical or commonsense manner, it will all be deductible under subsection 51(1) unless the expenditure is of a capital, private or domestic nature or was incurred in producing exempt income.

18. Where a weighing of all the relevant factors shows that the disproportion is explicable by considerations relating to the pursuit of some other aim and that only part of an outgoing is attributable to the actual or expected production of assessable income, it will be necessary to apportion that outgoing between the pursuit of assessable income and that other aim.

19. In *Fletcher* the outgoings of interest were incurred in borrowing money. Before they could be characterised as falling within the first limb of subsection 51(1) the use to which the borrowed funds were put had to be established. That use was in the payment of the purchase price under the annuity agreement and in repayment of interest under the scheme of loans. The High Court stated:

> 'If the assessable income actually derived under the annuity agreement in each of the tax years had been at least equal to the actual outgoings of interest, there would, in the absence of any other deductible expenses, have been little difficulty in characterising those outgoings as wholly incurred in gaining or producing that assessable income. In fact, however, the

assessable income derived from the annuity in each of the tax years was less than one-eighth of the adjusted outgoings of interest in that year.' (91 ATC 4950 at 4958; (1991) 22 ATR 613 at 623).

20. In examining all the circumstances and factors surrounding the transactions, the High Court took the view that if the taxpayers had not intended and expected the annuities scheme to run its full fifteen years at the time they entered it, and in fact intended to leave the scheme within the first five to ten years of its operation, when interest outgoings would far exceed the income from the scheme, the outgoings in excess of the income received could not be characterised as falling within the first limb of subsection 51(1).

21. The question of what was the intention of the taxpayers was remitted to the Administrative Appeals Tribunal which found that the taxpayers had not intended to remain in the scheme for the full fifteen years (*Fletcher & Ors. v. FC of T* 92 ATC 2045; AAT Case 5489 A (1992) 23 ATR 1068).

22. *Fletcher* has been referred to with approval in several Federal Court cases, including *McGuiness* v. *FC of T* 92 ATC 4006; 23 ATR 762 and *FC of T* v. *Roberts & Smith 93 ATC 4545;* 23 ATR 494. To the extent that Hill J may have implied in *FC of T v. Studdert* 91 ATC 5006; 22 ATR 762 that the principle in *Fletcher* is effectively limited to artificial tax avoidance schemes we can see no basis for any such implication.

Examples

Example 1

23. Mr Chancer receives a prospectus inviting participation as an investor in a cattle breeding scheme. The scheme promoters arrange for each investor to borrow $100,000 for the right to participate in the scheme. The interest is payable over the life of the scheme and is financed by a "round robin" of cheques. Under the scheme, substantial losses are to arise for investors in the first 5 years, small losses in the next 6 years and large net incomes over the final 5 years.

24. Over the 16 year agreement, the total of the anticipated assessable income is expected to exceed the total outgoings of interest. However, every investor has the option of terminating his or her participation before the large net incomes arise without incurring personal liability on any outstanding borrowings.

25. Mr Chancer considers the investment to be excellent in view of the tax deductions offered by the promoters.

26. A commonsense weighing of all the relevant evidence indicates that the scheme is not expected to run its full course and Mr Chancer's dominant purpose in entering the scheme is to incur the outgoings in order to minimise his tax liability. In the circumstances, as the total anticipated allowable deductions will far exceed the total assessable income expected to be derived until the time of termination, the excess of the outgoings over the assessable income will not be deductible under subsection 51(1).

Example 2

27. If the arrangement provides that Mr Chancer is absolutely locked in with no opportunity of leaving the scheme until its termination, the interest payments will be deductible under subsection 51(1). This is so, because over the 16 year life of the agreement, the total of the anticipated assessable income is expected to exceed the total outgoings of interest.

Example 3

28. If it is expected that Mr Chancer will terminate his participation during the final 5 years of the scheme, the interest payments might still be deductible under subsection 51(1). They will be deductible if Mr Chancer is expected to leave the scheme at a stage when the total of the anticipated assessable income will exceed the total outgoings of interest.

Example 4

29. Mr Skeam borrows $100,000 from his spouse at 17% interest in a non-arm's length transaction to finance the purchase of a rental property. The commercial rate of interest is 10%. Mr Skeam's dominant purpose in agreeing to pay the higher rate of interest is to obtain a greater tax deduction than if he makes the borrowing at 10% as well as to secure a financial benefit for his family to the extent of the excess of 7%.

30. Mr Skeam would only be allowed a deduction under subsection 51(1) at the rate of 10% for the period of the loan.

Example 5

31. Mr Skeam finally decides to borrow the money to buy the property at a commercial rate of interest of 10%. He borrows $70,000 of the purchase price of $100,000 with the ultimate aim of selling the property at a capital gain and at the same time setting off the interest deduction against his other income from his sandwich shop.
He expects to obtain an arm's length rental from the property.

32. The interest payments will be deductible under subsection 51(1) while the property produces rent, as the interest expenditure can be wholly characterised by reference to the actual or expected production of assessable income.

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- Fletcher & Ors v. FC of T (1991) 91 ATC 4950; 22 ATR 613
- Ronpibon Tin N.L and Tongkah Compound N.L. v. FC of T (1949) 78 CLR 47
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- Robert G. Nall v. FC of T (1936-1937) 57 CLR 695
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