TD 92/D222 - Income tax: if an employee incurs legal expenses recovering wages paid by a dishonoured cheque, are these legal expenses an allowable deduction under subsection 51(1)?

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Draft Taxation Determination

Income tax: if an employee incurs legal expenses recovering wages paid by a dishonoured cheque, are these legal expenses an allowable deduction under subsection 51(1)?

1. Yes, providing that the legal action relates solely to the recovery of assessable income, for example wages. This is because legal expenses take the quality of an outgoing of a capital or revenue nature from the cause or purpose of incurring the expenditure (*Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634).

2. Salary or wage income is only assessable when it has been derived, and salary or wages are only derived when paid. In *Tilley v Official Receiver in Bankrupcy* [1960] 103 CLR 529 at 535 Kitto J, in an observation on payment by cheque, stated that ' There can be no doubt that the acceptance of a payment by cheque implies, if there be nothing to the contrary, an agreement that it shall be considered as payment, subject to the condition subsequent that if the cheque be dishonoured it shall no longer be so considered.' In *Mackenzie v Rees* [1941] 65 CLR 1 at 15, Dixon J expressed a similar view.

3. Accordingly, where salary or wages are paid by dishonoured cheques, there is no payment of salary or wages and hence no derivation of income. It follows that if legal expenses are incurred in pursuing payment of those salary or wages, they are incurred before the income is derived, and are expenses incurred in the process of deriving that income. Consequently, they are deductible under section 51 of the *Income Tax Assessment Act 1936*.

4. Examples of costs which may be claimed include:

Solicitor's fees in pursuing the debt in court; Court costs; Costs associated with serving a legal process.

5. However, if the legal action goes beyond a claim for a revenue item such as wages, and constitutes an action for breach of the contract of employment, the legal costs would not be deductible because they are capital in nature. For example, legal expense relating to an action for damages for wrongful dismissal are not deductible.

Commissioner of Taxation
26/11/92

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