Abstract

Compensation: Does expenditure have to produce assessable income to be deductible? [1]

Expenditure incurred to derive assessable compensation amounts is generally deductible whereas expenditure incurred in deriving a taxable capital gain or other capital amount is generally not, but may be included in the cost base of a related asset. By contrast the deductibility of expenses incurred to maintain the income earning capacity of an existing business or its income earning assets is uncertain. The uncertainty arises because the primary objective of incurring those expenses may not be to derive assessable income in the current year but to maintain the income earning capacity of the relevant asset/business in the short and long term.

The research underlying this article critically evaluates the law related to deducting expenses incurred for the purpose of defending an existing income earning activity with particular emphasis on the ability to claim deductions for expenses incurred in seeking compensation for temporary and permanent damage to income earning assets. The availability of deductions to those liable to pay compensation is also evaluated and contrasted with the deductibility of expenses incurred by those claiming compensation amounts.

This article concludes that payers of compensation and their associated (legal and other) costs are in most cases entitled to a tax deduction for amounts paid where the liability to pay compensation arises in the course of their ordinary business activities, despite the fact that the payment may not directly relate to earning assessable income in the current or future years. By comparison the availability of deductions for expenses incurred to claim compensation and maintain the income earning capacity of business assets is far less certain particularly when damage to one or more assets is permanent. This article asserts that the existing preference towards allowing deductions to payers of compensation is not warranted and that a more equitable treatment should be extended to taxpayers incurring expenses to maintain their existing income earning capacity.

[1] This research project forms part of a PhD enrolment at the University of New South Wales under the supervision of Professor Chris Evans, UNSW and Professor Dale Pinto, Curtin University, Western Australia. The PhD will consist of a series of 4 or more published articles and this research paper forms part of the main research project which focuses on the taxation treatment of mining compensation payments with particular reference to the deductibility of expenses incurred in relation to non-assessable compensation amounts.

Introduction

"Might is not always right"[2]

History abounds with examples of powerful leaders exerting their might over weaker opponents and sometimes their own subjects. However, in a society governed by the rule of law, where principles of freedom and equity are enshrined, citizens should have comfort in knowing that the laws of the land do not favour the rich and powerful. To this end, institutions and regulations exist in most advanced democracies to ensure that those in positions of economic power do not abuse that power to the detriment of society as a whole.

The objective of this article is to evaluate our taxation system in the context of allowable deductions to determine if the law favours the powerful or whether it promotes greater competition and choice for consumers. Existing authority[3] confirms that expenditure incurred to enlarge an income earning asset or structure is not deductible. This approach provides a safeguard to competition by preventing the economically powerful from claiming tax deductions for expenditure incurred to reduce competition.

This article commences with a consideration of whether the payer of a compensation amount is entitled to an income tax deduction for compensation paid and for professional costs incurred in determining their liability to pay compensation. The analysis then proceeds with reviewing the deductibility of expenses (including legal, valuation, engineering, accounting and other consulting fees) incurred to claim compensation for damage to an income earning asset or structure.

It is submitted that in administering the law the Commissioner of Taxation has not always respected the essence of precedential authorities related to expenditure incurred to defend an existing income earning asset or activity and as a consequence may be inappropriately denying deductions and indirectly supressing competition. Guidelines are developed in this article for distinguishing between aggressive expenditure incurred by those with economic power from true defensive expenditure incurred by those with lesser economic power.

Methodology

The research methodology employed in this article is inductive legal reasoning.[4] This methodology draws upon primary sources of authority including legislation, cases and secondary sources of authority such as scholarly articles and the Commissioner of Taxation Rulings to construct propositions (theories) as to the application of deduction principles to expenditure related to protecting capital assets.

Background

The author's recent experience in applying for private rulings[5] concerning the deductibility of legal and other costs incurred to claim compensation amounts suggests that the Commissioner of Taxation may be seeking to incorrectly apply the law in relation to the deductibility of such litigation costs. The Commissioner[6] in taking his stance is relying on his public rulings and his interpretation of decided cases to deny deductions incurred to maintain an existing income earning activity/business. This article provides

[2] This phrase is an aphorism with several potential meanings but it is most often used as a negative assessment of the abuse of power by those with the capacity to abuse that position.
[3] Sun Newspapers Ltd v FCT [1938] HCA 72; Broken Hill Theatres Pty Ltd v Federal Commissioner of Taxation [1952] HCA 75.
[4] McKerchar, M., 2010, Design and Conduct of Research in Tax, Law and Accounting, Thomson Reuters, Sydney, chapter 5.
[5] The decision in one private ruling request has been deferred by the Commissioner pending further consideration of the law based on a substantial submission made by the author in applying for the private ruling request. The author has argued along the lines identified in this article that expenses to claim assessable and non-assessable compensation should be deductible.
[6] As operationalised by his staff.

evidence to suggest that the Commissioner's interpretation on these sources is questionable in some cases and his denial of expenses incurred to defend an existing income earning activity has the potential more generally to disadvantage parties with lesser economic power and as a result reduce competition in the market place.

Liability to pay compensation

Taxpayers may in the course of carrying on their business or other income earning activity incur a liability to pay compensation to another person. To be able to make a claim for compensation a person must have a right to seek compensation and Taxation Ruling TR 95/35[7] defines "a right to seek compensation", as:

> *The right to seek compensation is the right of action arising at law or in equity and vesting in the taxpayer on the occurrence of any breach of contract, personal injury or other compensable damage or injury.[8] A right to seek compensation is an asset for the purposes of Part IIIA.[9]*

It is evident that a right to seek compensation may be acquired in many different circumstances but prior to being able to bring an action for compensation a plaintiff will have to demonstrate that they have suffered an injury or loss. Where a compensation claim is brought under a statutory provision it is necessary for the plaintiff to demonstrate that they come within the scope of that statutory provision or alternatively the statute imposes a strict liability on the other party to provide compensation.[10]

The defendant in negotiating or litigating a compensation claim against them may incur a range of expenses including legal, valuation, consulting and other expenses. The purpose of incurring these expenses is generally to confirm that a liability to pay compensation exists and to determine the quantum of the compensation amount to be paid to the claimant. The amount of compensation is generally calculated on the basis of the quantum of loss, suffering or injury sustained and is generally designed to put the recipient in the position they would have been had they not sustained the loss, suffering or injury.[11]

Available deductions – litigation/negotiation costs and compensation paid

Legal expenses incurred[12] in the course of earning assessable income or in carrying on a business for the purpose of gaining or producing assessable income are generally deductible if the expenses satisfy the normal requirements for deductibility under the general deduction provision in s 8-1.[13] Expenses will not be deductible under s 8-1 where the loss or outgoing is of capital or capital in nature; or it is a loss or outgoing of a private or domestic nature; or it is incurred in relation to gaining or producing exempt income or non-assessable non-exempt income; or a provision of ITAA 97 prevents an entity from deducting it.[14] The question of whether legal expenses incurred by a taxpayer in defending/litigating a claim for compensation against them was addressed in the case of Herald & Weekly Times Ltd v FCT.[15] Gavan Duffy C.J. and

---

[7] Taxation Ruling TR 95/35 Income tax: capital gains: treatment of compensation receipts.

[8] The right to seek compensation is acquired at the time of the compensable wrong or injury, and includes all of the rights arising during the process of pursuing the compensation claim. The right to seek compensation is disposed of when it is satisfied, surrendered, released or discharged.

[9] This reference is to the Income Tax Assessment Act 1936. This legislation has been repealed and replaced by Part 3-1 and Part 3-3 of Chapter 3 of the Income Tax Assessment Act 1997.

[10] For example s 532(1) of the Petroleum and Gas (Production and Safety) Act 2004 (Queensland) imposes a strict liability on a petroleum authority holder to provide compensation, as follows:

> *The holder of each petroleum authority is liable to compensate each owner or occupier of private land or public land in the area of, or access land for, the authority (an eligible claimant) for any compensatable effect the eligible claimant suffers that is caused by relevant authorised activities.*

[11] Merriam Webster dictionary, accessed at http://www.merriam-webster.com/dictionary/compensation.

[12] FCT v James Flood Pty Ltd (1953) 88 CLR 492; Nilsen Development Laboratories Pty Ltd v FCT (1981) 144 CLR 616.

[13] Income Tax Assessment Act 1997 (ITAA97).

[14] Section 8-1(2) ITAA 97.

[15] Herald & Weekly Times Ltd v Federal Commissioner of Taxation [1932] HCA 56; (1932) 48 CLR 113.

Dixon J. described the nature of the taxpayer's activities and the relationship between the expenses and those activities as follows:[16]

> *The appellant publishes an evening newspaper from which it derives much of its assessable income. In the course of doing so, it is exposed to claims for defamation, some of which it settles upon terms which include a payment by way of compensation, others of which it litigates successfully or unsuccessfully, and most of which involve it in law costs.*

This extract provides us with a factual context in which legal expenses and compensation costs may be incurred. Gavan Duffy C.J. and Dixon J. then went on to state the key determinant to claiming tax deductions for these costs:

> *To establish the right to such a deduction, it is necessary for the taxpayer to show that the expenditure is a loss or outgoing (not being in the nature of a loss or outgoing of capital) actually incurred in gaining or producing the assessable income…*

In an earlier decision in this case in the Supreme Court of Victoria, Mann J. considered that the relevant expenditure was an inevitable consequence of the conduct of a newspaper business that actionable wrongs would sometimes be committed. Mann J. also acknowledged that allegations of wrongs would sometimes be without foundation. Mann J. concluded that the expenses were incurred in the ordinary course of carrying on a business but in relation to the question of whether the expenses were incurred for the purpose of earning or producing assessable income Mann J. concluded that the relevant expenditure was in no sense productive of assessable income. He considered that the expenditure was not in any sense productive of anything, or tending to the production of anything but was merely incurred to preserve the business or the assets of the business from depletion. In other words he rejected the view that the preservation of a business or the assets of a business could be considered to be an activity carried on for the purpose of gaining or producing assessable income.

In this respect it would appear that Mann J. was separating the event that gave rise to the need to incur the expenditure from the activity by which the taxpayer earned its assessable income. Gavan Duffy C.J. and Dixon J. in their High Court decision clarified this aspect as follows:

> *None of the libels or supposed libels was published with any other object in view than the sale of the newspaper.*

In this brief extract Gavan Duffy C.J and Dixon J. confirm that all activities including the activity of publishing a libellous piece in its newspaper were just part of the ordinary income earning activity of the taxpayer, and they went on to state this oft quoted extract from their decision:

> *The liability to damages was incurred, or the claim was encountered, because of the very act of publishing the newspaper. The thing which produced the assessable income was the thing which exposed the taxpayer to the liability or claim discharged by the expenditure.*

In this respect Gavan Duffy C.J. and Dixon J. were merely confirming Mann J's position that the reason for incurring the expense was founded in the core income earning activity of the taxpayer. However, Gavan Duffy C.J. and Dixon J. went on to disagree with Mann J's position that the expenses were not deductible because they were not productive of income, as follows:

> *It is true that when the sums were paid the taxpayer was actuated in paying them, not by any desire to produce income, but, in the case of damages or compensation, by the necessity of satisfying a claim or liability to which it had become subject, and, in the case of law costs, by the desirability or urgency of defeating or diminishing such a claim. But this expenditure flows as a necessary or a natural consequence from the inclusion of the alleged defamatory matter in the newspaper and its publication.*

This extract is critical to understanding Gavan Duffy C.J. and Dixon J's conclusion that the expenses are deductible because they were incurred as a natural consequence of carrying on business. Gavan Duffy CJ. and Dixon J. provide further support to their conclusion in this case by stating:

[16] In their joint judgement.

> *Expenditure in which the taxpayer is repeatedly or recurrently involved in an enterprise or exertion undertaken in order to gain assessable income cannot be excluded by sec. 25 (e)[17] simply because the obligation to make it is an unintended consequence which the taxpayer desired to avoid.*

Based on this extract it would appear that the learned justices may have been influenced to some extent by the fact that the expenditure was a regular outgoing incurred by the taxpayer. Would their decision have been different if the taxpayer had incurred a one off expense? They go on to address this question by providing guidance on where to draw the line in determining the extent of connectivity required between an expense of this nature and the income earning activities of the taxpayer, and state that it:

> *….lies in the degree of connection between the trade or business carried on and the cause of the liability for damages*.

Gavan Duffy C.J. and Dixon J make reference in this respect to the decision of Lord Loreburn L.C. in Strong & Co. v. Woodifield[18] where he stated:[19]

> *I think only such losses can be deducted as are connected with it in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader. The nature of the trade is to be considered…*

This extract confirms that deductibility of compensation amounts does not depend primarily on the regularity of paying compensation but on the basis of the degree of connectivity between the trade or business being carried on and the cause of the liability for damages.

It is expected that claims may be made against a taxpayer as a result of past activities (rather than current year activities) that were carried on for the purpose of earning assessable income. Gavan Duffy C.J. and Dixon J. comment on Mann J's decision in this respect and acknowledge:

> *No point is made of the fact that the publication took place in a former year, and properly so. The continuity of the enterprise requires that the expenditure should be attributed to the year in which it was actually defrayed.*

In other words the High Court found no difficulty[20] in concluding that even if the expenses were incurred in a later income year they would be deductible in that later year provided that sufficient connectivity can be found to earning assessable income.[21]

Connectivity with earning assessable income

The case of Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation[22] provides us with further confirmation that an outgoing should be sufficiently connected to earning assessable income for the relevant outgoing to be deductible. In that case the taxpayer conducted a departmental store in Perth and it was the practice every business morning for the cashier accompanied by another employee to take the previous day's takings to the bank some two hundred yards away and pay them in to the credit of the taxpayer. However on 5th August 1952, while on their way to the bank unarmed, the two employees were held up at gun point and robbed. An amount of cash or £3,031 was stolen and never recovered and the taxpayer was not insured against such a loss. The High Court in concluding that the loss was deductible

[17] *Income Tax Assessment Act 1922-1929*.
[18] (1906) A.C. 448.
[19] (1906) A.C. at p. 452.
[20] See also Placer Pacific Management Pty Limited v Commissioner of Taxation [1995] FCA 1362 for a discussion on expenses incurred after the relevant income earning activity has ceased.
[21] The Court in Ronpibon Tin (1949) 78 CLR 47 at 57 concluded that it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of assessable income which confirms that a loss or outgoing can be deductible even if it is incurred after the cessation of income earning activities. But in order to be deductible the occasion of the outgoing must be found in those income earning activities. See also Taxation Ruling TR 2004/4 - Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities for further discussion on when expenses may have sufficient connectivity to the relevant income earning activity.
[22] [1956] HCA 77.

made reference to the decisions of W. Nevill & Co. Ltd. v FCT;[23] Ronpibon Tin N.L. and Tongkah Compound N.L. v F;[24] in the context that the loss incurred by the taxpayer was part of the ordinary income earning activities of carried on by the taxpayer. In this respect the High Court stated:

> *Banking the takings is a necessary part of the operations that are directed to the gaining or producing day by day of what will form at the end of the accounting period the assessable income. Without this, or some equivalent financial procedure, hitherto undevised……other essential outgoings would stop and that would mean that the gaining or producing of the assessable income would be suspended.*

An interesting aspect of this extract is the fact that the loss was considered unavoidable because the only practical manner for depositing the takings from sales was to physically bring the money to bank. The Charles Moore's case confirms that the words "*incurred in gaining or producing the assessable income*" mean, "*in the course of gaining or producing the assessable income*" .

Voluntary and involuntary expenditure

Another aspect of the Charles Moore's case is the fact that the taxpayer was the target or the victim of the robbery and so the loss was not a voluntary outgoing in any respect. Accordingly, the case is authority for the fact that involuntary losses or outgoings may also be deductible if the outgoing has sufficient connectivity to the income earning activity of the taxpayer. In the context of voluntary or involuntary expenditure it could be suggested that the actual amount of compensation paid may be an involuntary outgoing while the quantum of legal and other expenses incurred to litigate a compensation claim are generally incurred for commercial expediency[25] but are still most likely deductible.

Where the right to compensation arises under a common law right or under a statutory power the actual compensation amount will not be discretionary from the perspective of the compensation payer. For example, s 532 Petroleum and Gas (Production and Safety) Act 2004 (Qld) provides that an authority holder has a general liability to compensate as follows:

> *532 General liability to compensate*
>
> *(1) The holder of each petroleum authority is liable to compensate each owner or occupier of private land or public land in the area of, or access land for, the authority (an eligible claimant) for any compensatable effect the eligible claimant suffers that is caused by relevant authorised activities.*
>
> *(2) A petroleum authority holder's liability under subsection (1) to an eligible claimant is the holder's compensation liability to the claimant.*

The case of Magna Alloys & Research Pty Ltd v FCT[26] dealt with the question of whether legal expenses incurred by the company for the purpose of defending its directors and agents charged with criminal offences were deductible to the company. The Federal Court concluded that the taxpayer's motive in incurring the expenditure was not the critical criterion for deductibility but that the more correct test was whether the expenditure was apt to serve the business purposes of the taxpayer. The conduct which was the subject of the charges involved the taxpayer's way of carrying on business or more particularly the marketing methods adopted to sell the company's products. The Federal Court concluded that the expenses were deductible and considered that the principle established by the High Court in FCT v Snowden & Willson Pty. Ltd.[27] applied.

While cases such as Magna Alloys & Research and Snowden & Willson represent instances where expenditure was incurred for commercial expediency rather than specifically for the purpose of earning

[23] [1937] HCA 9.
[24] [1949] HCA 15
[25] W. Nevill & Co. Ltd. v. Federal Commissioner of Taxation [1937] HCA 9; (1937) 56 CLR 290 ; Ronpibon Tin N.L. and Tongkah Compound N.L. v. Federal Commissioner of Taxation [1949] HCA 15; (1949) 78 CLR 47, at p 57.
[26] [1980] FCA 150.
[27] [1958] HCA 23; (1958), 99 CLR 431. See later discussion on this case.

additional assessable income cases such as Fletcher & Ors v FCT[28] provide examples of where the taxpayer's subjective purpose was significantly influenced by the desire to claim income tax deductions. Where a taxpayer has a dual purpose when incurring discretionary expenditure then it may be necessary to apportion expenses based on the relative purpose to earn assessable income and other purposes. Taxation Ruling TR 95/33[29] provides guidance on the relevance of the subjective purpose of the taxpayer when determining the deductibility of losses or outgoings and paragraph 2 of that ruling provides:

> *Expenditure will generally be deductible under subsection 51(1) (**now s 8-1 ITAA 97**)[30] if its essential character is that of expenditure that has a sufficient connection with the operations or activities which more directly gain or produce the taxpayer's assessable income, provided that the expenditure is not of a capital, private or domestic nature. The essential character of an expense is a question of fact to be determined by reference to all the circumstances.*

However if the expenditure directly produces no assessable income as in the case of legal expenses incurred to litigate a compensation matter then it may be necessary to examine all the circumstances surrounding the expenditure to determine whether the outgoing is wholly deductible.[31] Taxation Ruling TR 95/33, however concludes at paragraph 5 that:

> *If, after weighing all the circumstances, including the direct and indirect objectives and advantages, in a common sense and practical manner, it can be concluded that the expenditure is genuinely, and not colourably, used in an assessable income producing activity, a deduction is allowable for the loss or outgoing.*

Additionally, the case of W Nevill & Co Ltd v FCT[32] concluded that expenses incurred to reduce future expenditure and deliver operational efficiencies were deductible against assessable income.

Compensation paid for historical or prospective events

The foregoing analysis has essentially concluded that deductions can be claimed for compensation and associated expenses paid that relate to past events but can the same conclusion be applied to compensation paid for prospective events. Reference was made already to s 532 Petroleum and Gas (Production and Safety) Act 2004 (Qld) which requires an authority holder to negotiate a compensation agreement with the landholder or occupier of the land prior to being able to enter the land.[33]

Where the benefit of paying compensation in advance will be enjoyed by the payer over a period of time then it is appropriate to consider whether this advance payment is immediately deductible or whether it would be more correctly classified as a pre-payment and deductions spread over the over the "eligible service period".[34] There are special prepayment rules[35] that apply where an advance payment for interest, leases or a service is made.[36] Prepayments of compensation paid in accordance with s 532 Petroleum and Gas (Production and Safety) Act 2004 (Qld) may be sufficiently related to the construction of coal seam gas

---

[28] (1991) 22 ATR 613.

[29] TR 95/33 - Income tax: subsection 51(1) - relevance of subjective purpose, motive or intention in determining the deductibility of losses and outgoings.

[30] Reference to ITAA97 inserted by the author.

[31] Paragraph 4, Taxation Ruling TR 95/33.

[32] [1937] HCA 9. Rich J, in his decision on the deductibility of this expenditure, stated:

> *In my opinion the sum constitutes an expenditure on account of income and it was wholly and exclusively laid out for the production of assessable income. ... The company's purpose in effecting the transaction was to save the salary and at the same time to put an end to joint control. In such an expenditure I can see no characteristics which would make it referable to capital account. There is nothing analogous to the acquisition of a fixed asset, to the enlargement of the goodwill of a company or …. to the rescue of the business from annihilation.*

[33] In addition the authority holder should compensate the landowner or occupier for accounting, legal or valuation costs necessarily and reasonably incurred to negotiate or prepare a conduct and compensation agreement, s 532(1)(b) Petroleum and Gas (Production and Safety) Act 2004 (Qld).

[34] As defined in s 82KZL(2) ITAA 36.

[35] Subdivision H Division 3 Part III ITAA 36 or ss 82KZL to 82KZO ITAA 36.

[36] Note that certain exemptions to the prepayment rules exist including payments less than $1,000, payments of salary and wages and compulsory payments.

wells (depreciating assets) and as a result it may be more appropriate that the compensation paid is included in the cost[37] of the depreciating asset[38] and as a consequence deductible over the effective life of the coal seam gas well.[39]

Conclusion – Compensation payments and related expenses

It can be concluded that an immediate deduction is generally available for compensation paid as well as litigation and negotiation costs incurred where the cause of the compensation claim has arisen from the ordinary income earning activities of the payer. This will be the case even where no assessable income is directly produced as a result of incurring the expenses. By contrast where compensation paid relates to future events then it is appropriate to consider whether the pre-paid compensation brings into existence an asset of enduring benefit and if such an asset is a depreciating asset the related costs can be expensed over the effective life of that asset.

Expenses incurred to claim compensation

It is acknowledged that compensation which takes the place of an amount that would otherwise be assessable will generally be assessable to the recipient on a receipts basis[40] whereas compensation for permanent damage to capital gains tax assets will generally reduce the cost base of the impacted asset.[41] To confirm entitlement to and the quantum of compensation it is generally necessary for the party claiming the compensation to incur legal, valuation, accounting, consulting and other costs. These expenses are expected to be incurred for commercial expedience to ensure that the entity is compensated wholly for the loss or damage sustained.[42]

Section 532 Petroleum and Gas (Production and Safety) Act 2004 (Qld) provides that an authority holder has a general liability to compensate an owner and occupier of land for damage that is likely to arise as a result of authorised activities to be carried out on the land. It is unlikely that any change in characterisation of the costs would occur if the objective of negotiating the compensation is to determine the amount to be paid for existing or future permanent damage to the land.[43] While this Act enables the claimant to receive recoupment of "reasonable"[44] costs in many cases the claimant is out of pocket.

Litigation costs – Purpose

In determining the deductibility of expenditure the primary pre-requisite is that the taxpayer should incur the expenditure for the purpose of earning assessable income.[45] It is recognised that certain expenditure including fines, penalties and bribes will not be deductible.[46] While the receipt of an assessable

---

[37] Subdivision 40-C ITAA97.

[38] Section 40-190(1) ITAA 97 provides that the second element is worked out after you start to hold a depreciating asset. The second element costs include an amount that is taken to be paid for each economic benefit that has contributed to bringing the asset to its present condition and location from time to time since the taxpayer commenced holding the asset.

[39] Taxation Ruling TR 2015/2, Table A provides that the effective life of gas wells and downhole equipment is 10 years.

[40] Delany T*, Reference to Article 1 in PhD Thesis…..*.

[41] Generally, the compensation will not be included in assessable income at the time of receipt but the impact of the reduced cost base will be relevant in determining the capital gain or capital loss when the asset is ultimately disposed. For further guidance see Taxation Ruling TR 95/35.

[42] W. Nevill & Co. Ltd. v. Federal Commissioner of Taxation [1937] HCA 9; (1937) 56 CLR 290 ; Ronpibon Tin N.L. and Tongkah Compound N.L. v. Federal Commissioner of Taxation [1949] HCA 15; (1949) 78 CLR 47, at p 57.

[43] It is acknowledged that under s 532(4)(b) Petroleum and Gas (Production and Safety) Act 2004 (Qld) a eligible claimant is entitled to receive a reimbursement of accounting, legal or valuation costs the claimant necessarily and reasonably incurs to negotiate or prepare a conduct and compensation agreement.

[44] Generally energy companies place monetary limits on the costs that may be reimbursed and where the actual costs exceed these monetary limits the claimant has to fund these costs from their own resources.

[45] John Fairfax & Sons Pty Ltd v FCT (1959) 101 CLR 30; Hallstroms Pty Ltd v FCT (1946) 72 CLR 634. Taxation Ruling TR 95/33 provides detailed guidance on the relevance of the taxpayer's subjective purpose, motive or intention in determining deductibility of general expenses. See earlier discussion in this article.

[46] See Taxation Ruling TR 93/25 Income tax: Assessability of proceeds from illegal activities, treatment of amounts recovered and deductibility of fines and penalties.

compensation amount may make it appear easier to satisfy the requirement that the purpose of the expenditure was to earn assessable income[47] the fact that no assessable income is actually produced in the current year should not of itself deny the taxpayer an entitlement to claim an income tax deduction for the litigation costs, provided the purpose of the expenditure was to generate assessable income in the short and long-term.[48]

Litigation costs incurred to maintain an existing income earning position

In Commissioner of Taxation v Day[49] the taxpayer incurred costs to defend his actions and to maintain his current employment position (income earning activity) and the High Court concluded that for the expenses to be deductible there must be a close and immediate connection with earning the assessable income. In this respect the High Court were not suggesting that the related assessable income should be derived immediately but that there must be a sufficient nexus with an income earning activity for the related legal expenses to be deductible. In the joint judgment of Gummow, Hayne, Heydon and Kiefel JJ[50] they confirmed that the occasion of Day's legal expenses was connected to his income earning activity:

> *… What was productive of his income by way of salary is to be found in all the incidents of his office in the Service to which the Act referred, including his obligation to observe standards of conduct, breach of which might entail disciplinary charges. The respondent's outgoings, by way of legal expenses, followed upon the bringing of the charges with respect to his conduct, or misconduct, as an officer. …..*[51]

It is important to acknowledge that Mr Day was defending himself against disciplinary action which if found guilty may have led to him losing his position as a custom's officer. As a consequence a conclusion that may be drawn from the Day case is that expenses incurred for the purpose of maintaining an existing income earning activity may be deductible.

The Day decision brings into question the correctness of the Commissioner's approach set out in paragraph 5 of Taxation Determination TD 93/29, where he stated:

> *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 where the essential character of the advantage sought relates to an enduring advantage that is of a capital nature, the legal costs would not be deductible. ….*

Given that over six years have passed since the Day decision has been decided it would appear appropriate that the Commissioner should reconsider his position in TD 93/29 to acknowledge that expenses may be deductible if they were incurred to maintain an existing income earning activity.

The case of FCT v Rowe[52] dealt with the question of whether legal expenses incurred to defend the taxpayer from disciplinary actions were deductible.[53] In relation to the availability of deductions the Federal

---

[47] Taxation Determination TD 93/29. Paragraph 4 confirms that court costs and costs associated with serving legal process will also be deductible. On the basis of this guidance it is reasonable to conclude that all costs reasonably incurred in litigating a compensation claim for the purpose of earning assessable income would be deductible.

[48] Magna Alloys & Research Pty Ltd v FC of T [1980] FCA 150 and Ronpibon Tin N.L. v. FC of T (1949) 78 CLR 47 at 59.

[49] [2008] HCA 53.

[50] At paragraph 37.

[51] See also Herald & Weekly Times Ltd v Federal Commissioner of Taxation [1932] HCA 56; (1932) 48 CLR 113 at 120 for further discussion on this point.

[52] [1995] FCA 1611.

[53] There was a secondary issue in this case which was whether recouped legal expenses were assessable. The Federal Court concluded that the receipt was too remote to the employment of the taxpayer to be considered to be assessable and was more correctly classified as compensation for the loss of good name and reputation of the taxpayer. In coming to its conclusion the Federal Court distinguished Federal Commissioner of Taxation v Dixon [1952] HCA 65; (1952) 86 CLR 540; and, Smith v The Commissioner of Taxation [1987] HCA 48; (1987) 164 CLR 513. See also Commissioner of Taxation v Anstis [2010] HCA; [2010] HCA 40; (2010) 241 CLR 443; Commissioner of Taxation v Firth [2002] FCA 413; (2002) 120 FCR 450; Schokker v Commissioner of Taxation [1999] FCA 600; (1999) 92 FCR 54.

Court in Rowe made reference to the case of Inglis v FCT[54] where the cost of proceedings brought by a public servant against her employer to protect her working arrangements from the imposition of restrictions were considered to be deductible. It is noted that in the Inglis case the taxpayer's position of employment was not at risk. However, Mr Rowe was employed by Livingstone Shire Council as its Engineer, was suspended from duty, and required by the Council to show cause why he should not be dismissed by reason of several complaints made against him. In other words there was clear and present danger that he would lose his employment position.

The Federal Court in Rowe recognised that in many respects the expenses that were being incurred by Rowe could be attributed a capital character. The Federal Court however referred to the dictum of Dixon J in Hallstroms Pty Ltd v FCT[55] to support an argument that while expenses may have a capital flavour that this in itself is not determinative of whether the expenses will be deductible:

> *…The claim is to deduct legal expenses, and legal expenses, we may assume, take the quality of an outgoing of a capital nature or of an outgoing on account of revenue from the cause or the purpose of incurring the expenditure…*

This extract confirms that even if the expenditure has a flavour of capital this will not deny deductions for the related expenses if the reason for incurring the expenses is to protect a taxpayer's ability to continue to earn income from an existing income earning activity. Both the Day and Rowe case did not involve a specific claim for compensation but the purpose of the expenditure was for the maintenance of a current income earning position. It is appropriate to determine whether incurring cost for the purpose of claiming non-assessable compensation has a comparable economic effect to incurring costs to maintain an existing income earning position.

Capital expenses

Assuming that the litigation expenditure has the relevant connection to earning assessable income[56] it is recognised that a prohibition exists on claiming expenses of a capital nature in s 8-1 ITAA 97. The relevant extract from s 8-1 ITAA 97 is as follows:

> *(2) However, you cannot deduct a loss or outgoing under this section to the extent that:*
>
> *(a) it is a loss or outgoing of capital, or of a capital nature…*

Accordingly it is critical that we clarify what is meant by an expense of a "capital nature" and whether expenses incurred to claim non-assessable compensation stamp the expenditure with that characteristic.

Economic equivalence

The manner in which the non-assessable compensation is calculated may include taking into account the reduced future income earning capacity of an asset but despite the fact that the calculation of the compensation amount may recognise the potential assessable income foregone the nature of the compensation amount is most likely to compensate for a loss of capital.[57] This follows the decision of the House of Lords in Glenboig Union Fireclay Co Ltd v IRC[58] where a railway company paid compensation to the taxpayer based on the value of unworked minerals because it had exercised its statutory rights to stop

[54] (1987) 87 ATC 2037.
[55] [1946] HCA 34; (1946) 72 CLR 634 (at 647).
[56] Positive limbs of s 8-1 ITAA97.
[57] For further discussion on the taxation of compensation amounts see, Black, Warren - "Tax Implications to Native Title Holders of Compensation Payments" [1999] JlATax 22; (1999) 2(5) Journal of Australian Taxation 344.
[58] (1922) 12 TC 427.

the taxpayer mining on its land. It was held by majority that the payment was capital in nature.[59] Buckmaster L stated:[60]

> *What we must consider is not the measure by which the amount of compensation was arrived at but what it was truly paid for ...*

Fundamental to this statement is a recognition that the current capital value of an asset will include its future income earning capacity and so as a result of the Glenboig case if a taxpayer is compensated for the loss of that future income earning capacity before the income is actually liberated from the asset then the compensation amount will be considered to be capital in nature. The manner by which the compensation is calculated will generally remove any actual or perceived tax advantage of receiving a non-assessable amount because the compensation paid will be reduced for any tax liability on any income foregone.[61] In other words the actual amount of compensation received irrespective of whether it is assessable or non-assessable will be comparable in an economic sense.[62]

Commonly non-assessable compensation will compensate the taxpayer for permanent damage to an asset and as a consequence the recipient will be placed in a comparable position to what they were in prior to the damage affecting their income earning asset. Before the event leading to the right to seek compensation the taxpayer will have had an income earning asset of a particular value, say $1 million. After sustaining damage to the asset to the extent of say $400,000[63] the asset will have a reduced value of $600,000. If the taxpayer is successful in claiming compensation of $400,000 then their net economic position will be returned to $1 million having an asset worth $600,000 and cash compensation of $400,000.

As the relevant asset has sustained damage, to get it back to its former income earning position the cash received will have to be expended on the asset[64] and so the receipt of the non-assessable compensation will not have delivered an economic improvement in the financial position of the recipient. Based on this analysis there is substantial economic comparability between incurring cost for the purpose of claiming non-assessable compensation and incurring costs to maintain an existing income earning position because they both achieve the same economic effect.

"Capital in nature"

The leading case on determining whether expenses are capital in nature is Sun Newspapers Ltd v FCT[65] and in that case Dixon J outlined guidelines to be considered in determining whether a loss or outgoing is of a capital or revenue nature:

> *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 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.*

---

[59] The decision in Glenboig has been followed in Australia by cases such as Federal Coke Coy Pty Ltd v FC of T 77 ATC 4255.
[60] At page 456.
[61] The case of British Transport Commission v Gourley [1955] UKHL 4 [1956] AC 185 established the principle that notional tax savings must be taken into consideration when calculating damages in order to ensure that the plaintiff is not overcompensated for its loss. In other words in determining the loss from the income foregone due to the damage to an asset any tax payable on that income should be offset against the income foregone thus ensuring that the taxpayer is not over compensated for the loss of income. In the case of the Commissioner of Taxation v Sydney Refractive Surgery Centre Pty Ltd [2008] FCAFC 190 the damages awarded was reduced by 36 percent, representing the estimated tax payable on the foregone taxable income in determining the compensation amount. The resulting compensation amount was considered to be a non-assessable receipt.
[62] The assessable compensation will generally be liable to taxation upon receipt and the non-assessable compensation will already be reduced for any potential tax advantage by operation of the Gourley principle. See note 61.
[63] Calculated based on the Gourley principle.
[64] If any amount of the costs is deductible, eg., repairs under s 25-10 ITAA97 then Division 20 ITAA97 may have the effect of converting some non-assessable recoupments into assessable recoupments.
[65] [1938] HCA 72.

When applying Dixon J's statement to litigation costs we need to determine if the costs were incurred to maintain the current income earning structure or whether they were incurred to enlarge it. There are other authorities supporting the application of the principle in the Sun Newspapers case and one such authority is the High Court decision in G.P. International Pipecoaters v FCT[66] where the High Court emphasised the need to determine the nature of the advantage sought, stating:

> *The character of expenditure is ordinarily determined by reference to the nature of the asset acquired or the liability discharged by the making of the expenditure, for the character of the advantage sought by the making of the expenditure is the chief, if not the critical, factor in determining the character of what is paid: Sun Newspapers Ltd and Associated Newspapers Ltd v FCT (1938) 61 CLR 337, at 363; 1 AITR 353; ...*

In evaluating the character of the advantage sought it is important to determine if the advantage secures an enduring benefit for the business.

Character of the advantage sought

Viscount Cave in British Insulated and Helsby Cables Ltd v Atherton[67] discussed the concept of enduring benefit where he stated:

> *But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.*

Essentially if the expenditure produces some asset or economic advantage of a lasting character (enduring benefit of trade) for the betterment of the organisation or income earning activity it is likely to be capital in nature. Accordingly, for an expense to be capital in nature there must be something additional produced such as an asset or a separate advantage or attribute to an asset that did not exist previously. By inference, where a business is merely seeking to retain or sustain an income earning position or asset it currently has this should not result in the expenditure being characterised as being capital in nature.

Following the decision in Sun Newspaper the High Court in the case of Hallstroms Pty Ltd v FCT[68] concluded that expenses that went to the heart of a business' existence were not necessarily capital in nature. In Hallstroms, the appellant company was engaged in the manufacture and sale of domestic refrigerators. Hallstroms paid its own legal costs to defend its ability to continue to use a particular patent and the issue in the case was whether those legal expenses were deductible under s 51(1) ITAA 36.[69] While acknowledging the principles established in the British Insulated and Sun Newspaper cases the High Court in Hallstroms provided another nuance to those established principles, where Latham CJ stated:

> *In my opinion the expenditure by the company was not made for the purpose of acquiring an asset or of adding to the profit yielding subject which constituted the capital structure of the business but, as Lord Hanworth M.R. said in Mitchell v. B. W. Noble Ltd.[70], the expenditure was made "not in order to secure an actual asset to the company but to enable them to continue, as they had in the past, to carry on" the same business, unfettered by a particular difficulty which had arisen in the course of the year….A right enjoyed in common with all persons is not a capital asset of any single person… It simply maintained its position as it already existed.*

The critical aspects of this extract is that the taxpayer did not acquire a right or an asset because the right to manufacture was a right that was available to everyone and the fact that the taxpayer merely maintained its position or the rights that it already held. This last attribute being the maintenance of the status quo resonates with a litigant's purpose of incurring litigation costs to claim compensation and retain their current trading position. If the Hallstroms' principle were applied to compensation litigation costs incurred primarily

[66] (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1.
[67] [1926] AC 205 at 213 – 214.
[68] [1946] HCA 34; (1946) 72 CLR 634.
[69] Now section 8-1 ITAA97.
[70] (1927) 1 K.B. 719, at p. 737; [1927] EWCA Civ 1; 11 Tax Cas. 372, at p. 421.

to maintain the income earning capacity of their business or assets on a prospective basis those litigants should be able to claim deductions for those costs.

Costs incurred to reduce competition

The High Court reviewed the deductibility of costs to reduce or eliminate competition in the case of Broken Hill Theatres Pty Ltd v FCT.[71] In that case the taxpayers incurred expenditure to object to an application for the grant of a new license to operate a new theatre in Broken Hill. The taxpayer at the relevant time held the majority of the theatre market in Broken Hill and from time to time it would object to applications for new licences. While the High Court recognised that a number of applications for licenses had been made and objected to by the taxpayer previously it could not predict with certainty whether there would be future applications and Dixon C.J., McTiernan, Fullagar and Kitto JJ, commented:

> *At the time when it was made, nobody could say whether Boulus or anybody else would or would not make another application in two or five or ten years' time.*

Webb J in a separate judgement in the Broken Hill Theatres case distinguished the decision in Hallstroms on the basis that the benefit from the extension of the patent in Hallstroms was for a discrete period (no enduring benefit) whereas the duration of the benefit derived by Broken Hill Theatres was indefinite. The joint decisions of Dixon C.J., McTiernan, Fullagar and Kitto JJ in the Broken Hill Theatres case concurred with this sentiment:

> *The recurrent character of expenditure has been said more than once to be an element which may throw light on the question whether that expenditure is or is not an outgoing of a capital nature. But, in our opinion, the expenditure in the present case cannot be regarded as "recurrent" in the relevant sense.*

Accordingly, the High Court concluded that in the absence of information on new applications for licenses the successful objection to the current application may give the taxpayer a benefit of an enduring nature. It is interesting to note that WJV Windeyer Q.C. for the respondent in the Broken Hill Theatre case linked the nature of the payment in Sun Newspapers (payment to reduce competition) with the payment made by Broken Hill Theatres, as follows:

> *Expenditure to buy out a competitor has been held to be of a capital character. It is immaterial whether the money be paid to buy out or, by legal proceedings, to knockout threatened competition.*

Accordingly, Windeyer identified that the objectives of the payments in both cases was to reduce competition despite their differing forms.

While the High Court's primary stated reason for denying deductions in Broken Hill Theatres was because the expenses delivered an enduring benefit the effect of the decision was to deny a deduction to a party with substantial existing economic power. If the High Court were to have allowed that deduction it would have delivered additional economic power to the party claiming the deduction. This would not serve the interests of consumers who are generally better served by a greater level of completion in a particular market.

In the case of John Fairfax & Sons Pty Limited v FCT[72] the taxpayers sought a deduction for legal expenses that were incurred to defend certain actions of the company which had the effect of expanding the commercial scope of its operations. Dixon CJ in his decision in John Fairfax provides us with some explanation as to why the expenses in that case were capital and non-deductible in nature:

> *No doubt it is not often that an outgoing is voluntarily incurred without anything to show for it. … It is however a feature that is always likely to occur when the purpose of the expenditure is to limit or*

[71] [1952] HCA 75.
[72] [1959] HCA 4.

> *buy off opposition or forestall or get rid of some present or threatened disadvantage. Of course you can have expenditure of that kind which on the soundest principles of accounting is chargeable against revenue. But you might confidently expect to find that much expenditure of the kind was undeniably on capital account.*

It is clear that the thread that flows through Dixon CJ's decisions in Sun Newspapers, Broken Hill Theatres and John Fairfax is that any amount that seeks to reduce or eliminate competition is most likely to be capital in nature. The Commissioner position[73] that expenses incurred to maintain an existing position are capital comes largely from the judgement of Menzies J in John Fairfax, wherein Menzies stated:

> *…I see the outgoing, as I have already said, rather as part of the expense of adding to the appellant's capital than as an expense of maintaining a capital asset but even if it be assumed that its true character was a payment to protect a capital asset that had already been acquired I would still be disposed to regard it as of a capital nature.*

This last comment by Menzies J, that even if the expenses were *to protect a capital asset* they would be capital in nature was obiter dicta and was un-necessary in the context of the decision in John Fairfax. It was inappropriate for Menzies J to make any assumptions about the nature of expenses that were not part of the case before him. He should have confined his decision to the facts and not made broad sweeping statements. Clearly the decision in Hallstroms where the High Court allowed a deduction for costs of protecting an income earning position was not prominent in Menzies J's mind. It is also observed that Menzies J in his decision had already concluded that the expenses incurred by John Fairfax did not satisfy the positive limbs and he provided his commentary on expenses of a capital nature as an aside:[74]

> *This conclusion in strictness[75] makes it unnecessary for me to consider whether the outgoing was of a capital nature but as I have reached the conclusion that it was I will state my reasons for so thinking.*

While Menzies J considered it strictly unnecessary to make any comment as to the capital nature of expenses he was happy to put his thoughts out there. As with many obiter comments, they must be considered in the context that they were made and as they refer to a hypothetical proposition they do not deserve the same (if any) emphasis as the ratio decidendi in the case which was based on the facts before the court.[76] It should be acknowledged that in any event that Menzies J was only "disposed" towards making a particular finding. Clearly it is going too far for the Commissioner to rely on these obiter comments to conclude that the John Fairfax case was establishing a general principle that all expenses incurred to defend an existing income earning activity or asset are capital in nature.

Commissioner's position

In addition to the Commissioner's stated understanding of the deductibility of expenses incurred to defend an existing income earning position in Taxation Determination TD 93/29 other examples of the Commissioner's interpretation exist. In Taxation Ruling TR 95/1[77] the Commissioner considers whether advertising costs associated with opposing legislation is a deductible expense. The ruling was issued as a result of the decision of the Federal Court in the case of FCT v Rothmans of Pall Mall (Aust) Ltd[78] which concluded that advertising costs involved in opposing the passing of legislation that may affect the market share but does not threaten the existence of its business may be allowable. In relation to the concept of capital expenditure Lockhart J made reference to Latham CJ's statement in Hallstroms Pty Limited v FCT:[79]

---

[73] See for example paragraph 5 of Taxation Determination TD 93/29.
[74] At page 51.
[75] That the expenses are not incurred in the course of earning assessable income or do not satisfy the positive limbs.
[76] Unlike the obiter dicta the ratio decidendi is, as a general rule, binding on courts of lower and later jurisdiction—through the doctrine of *stare decisis*.
[77] Taxation Ruling TR 95/1 Income tax: deductibility of advertising that opposes the passing of legislation. As a consequence of issuing TR 95/1 Taxation Ruling IT 2491 was withdrawn.
[78] 92 ATC 4508; (1992) 23 ATR 620.
[79] [1946] HCA 34; (1946) 72 CLR 634.

> *Nor can it be said that the company, by making the expenditure, gained 'an enduring advantage'. It gained nothing - it merely succeeded in maintaining an existing position. The prevention or avoidance of a loss is not a gain of anything. The prevention of subtraction is not the same thing as addition.*[80]

Lockhart J stated what he understood to be the purpose of the expenditure:

> *The expenditure by Rothmans was to defeat the passage of legislation which would curtail sales and advertising of tobacco products and probably result in loss of market share of Rothmans. There was no threat to the existence of Rothmans' business or to any capital asset of that business.*

The Commissioner's interpretation of the Rothmans' decision as evidenced in TR 95/1, was as follows:[81]

> *…..expenditure to the extent that it opposes legislation that threatens the existence of the business framework in some way is not deductible under subsection 51(1) of the Act…*

In making this statement the Commissioner uses the term "business framework" whereas Lockhart J makes reference to the existence of the Rothmans' business and the assets of the business. An interpretation that could be attributed to the term business framework is that it includes the capital structure of the business but could it extend to a restructure of the business to continue to deliver the same goods and services but in different proportions. Whatever the Commissioner had in mind in using the term "business framework" taxpayers should resolutely reject any constriction on the application of the Rothmans' decision where the existence of the business is not at risk.

In ATO Interpretative Decision ID 2004/867[82] the Commissioner makes the following statement:[83]

> *Outgoings incurred in the preservation of an existing capital asset have been held to be capital in nature (John Fairfax & Sons Pty Limited v. Federal Commissioner of Taxation (1959) 101 CLR 30; (1959) 7 AITR 346; (1959) 11 ATD 510).*

This can hardly be considered to be a correct statement of the law given that the case concluded that expenses incurred for the purpose of expanding income earning activities were denied deductibility. Notwithstanding the role of interpretive decisions and restricted amount of discussion of the John Fairfax case in the interpretive decision it would appear inappropriate that the Commissioner should publish such bold faced statements without some clarification. The presence of such a statement is potentially confusing to the Commissioner's own staff as well as taxpayers and their professional advisers.[84]

Where expenses are incurred for the purpose of receiving both assessable and non-assessable compensation amounts an incomplete evaluation of the transaction may suggest that only that portion of the expenditure related to claiming the assessable compensation should be allowed as a deduction.[85] Taxation Determination TD 93/29 undertakes such an incomplete evaluation and provides the following guidance in relation to apportionment of legal expenses incurred to earn assessable and non-assessable compensation amounts:[86]

> *Where the solicitor's account is itemised, one reasonable basis for apportionment would be the time spent involving the revenue claim, relative to the time spent on the capital claim. If the solicitor's*

[80] At page 641.
[81] At paragraph 11 of the ruling.
[82] ATO Interpretative Decision ATO ID 2004/867 Income tax - Deduction: expenses incurred in obtaining a property valuation to maintain an entitlement to a pension
[83] In the "reasons for decision" section.
[84] The Commissioner in Taxation Ruling TR 2011/6 states that the case of John Fairfax & Sons Pty Ltd v Federal Commissioner of Taxation (1959) 101 CLR 30; (1959) 11 ATD 510; (1959) 7 AITR 346 concluded that a capital expense can also result in the reduction of capital. Menzies J actually considered that payments for the disposal of unwanted capital assets in addition to reducing the capital of the business may be capital costs.
[85] Section 8-1 ITAA 97 provides that expenditure will be deductible to the extent that it is incurred for the purpose of earning assessable income or was incurred in the course of earning assessable income.
[86] Taxation Determination TD 93/29, paragraph 7.

account is not itemised, a possible basis for apportionment would be either a reasonable costing of the work undertaken by the solicitor in relation to the revenue claim, or, where this is not possible, an apportionment on the basis of the monetary value of the revenue claim relative to the capital claim.

This Determination goes on to provide an example of an acceptable methodology that may be employed in apportioning expenses.[87] While not suggesting that the principles set out in this Determination, based on the facts, are incorrect, there is a significant risk that a reader may inappropriately conclude (based on the example) that it is establishing a general principle that expenses incurred to claim non-assessable compensation are capital in nature and not deductible.

It is acknowledged that the determination[88] clarifies that expenditure will be capital in nature if the essential character of the advantage sought relates to an enduring benefit. Notwithstanding, how could the determination indirectly conclude that the expenses were incurred to give the taxpayer an enduring benefit given that the taxpayer had already ceased his income earning activity (he was already dismissed) and the reason for bringing the action was solely to claim a non-assessable amount. Accordingly, it appears that the Commissioner has muddied the waters by discussing concepts of the character or advantage sought in the context of an income earning activity that had ceased.

The foregoing discussion demonstrates that the Commissioner[89] has somewhat erroneously relied upon the decision in the Broken Hill Theatre case and the decision in John Fairfax & Sons Pty Limited v FCT to cobble together the principle that outgoings incurred in the preservation of an existing income earning capital asset are not deductible.

The High Court decision in FCT v Day[90] clearly rejects the broad statement of Menzies J in John Fairfax that expenses incurred to protect a capital asset would be capital in nature. It is acknowledged that on the facts in John Fairfax a significant purpose of the expenditure was to defend actions that had the effect of expanding the taxpayer's profit making structure. By contrast litigation costs incurred to sustain the business entity, structure or organisation are not incurred for the purpose of expanding the income earning structure or eliminating competition from the market place.[91]

In the case of Sunraysia Broadcasters Pty Ltd v FCT,[92] expenses incurred by an AM radio station in obtaining a supplementary FM licence, primarily to forestall competition, were not deductible as they were incurred in enhancing the business enterprise itself and it is evident that this decision links to the capital classification of competition reduction expenses incurred in the Sun Newspapers, Broken Hill Theatres and John Fairfax cases.[93]

---

[87] Example:

Andrew B is dismissed by his employer. He consults a solicitor who advises that he is entitled to wages, severance pay and damages for wrongful dismissal. The solicitor sends a letter of demand for payment of $5,000 (wages and severance pay) and institutes legal proceedings in respect of the wrongful dismissal. Upon receipt of the letter of demand, the employer pays the amount of $5,000, but he decides to defend the action for wrongful dismissal. After 15 months of negotiations, Andrew receives a further $5,000 for wrongful dismissal in an out-of-court settlement. He also receives an account from his solicitor for $3,000, which he pays. The account is not itemised.

Andrew includes a deduction of $100 for legal expenses in his return. This amount is acceptable because only one letter was written by the solicitor to recover the wages and severance pay. The balance of $2,900 is not deductible.

If the letter of demand had not resulted in payment, and legal proceedings had been instituted which led to a settlement of $5,000 for wages and severance pay, as well as $5,000 for wrongful dismissal, a deduction of $1,500 would be reasonable, the apportionment being based on the size of the revenue amount relative to the capital amount.

[88] In paragraph 5.

[89] For example Taxation Determination TD 93/29.

[90] [2008] HCA 53.

[91] See cases such as Hallstroms Pty Ltd v FCT (1946) 72 CLR 634.

[92] (1991) 22 ATR 115.

[93] See also Smithkline Beecham Laboratories (Australia) Ltd v FCT (1993) 26 ATR 260 - where legal costs incurred in litigation commenced with a view to preventing competitors from obtaining marketing approval of a product competing with a product of the applicant were considered to be capital in nature.

By contrast, in the case of FCT v Duro Travel Goods Pty Ltd[94] the High Court held that legal expenses incurred in protecting the taxpayer's interest in its exclusive trademark were deductible. Taylor J stated his position as follows:[95]

> *It may be conceded that the expenditure under consideration in this case may have operated to increase the value of the respondent's goodwill, but this circumstance does not, in my opinion, fix the expenditure in question with the character of capital expenditure. … The undertakings did not secure for the respondent freedom from trade competition, nor were the negotiations and proceedings as a result of which they were obtained, undertaken to protect the respondent against any attack on its right to use its trade name or trademarks…*

Quite simply Taylor J was concluding that the legal expenses incurred by Duro Travel did not deliver an expansion of the income earning structure nor an enduring benefit and accordingly were not capital in nature. The cases of Duro Travel and Hallstroms appear to have a similar theme being that expenses incurred to defend a current position are not capital in nature and accordingly were deductible.

Defensive v offensive expenditure

Pincus J in his single judge decision in the Federal Court of Consolidated Fertilizers Ltd v Federal Commissioner of Taxation[96] makes reference to the higher likelihood of deductibility where expenses are incurred to defend a position (as in Hallstroms case), where he stated:

> *They make relevant, as a factor tending to support deductibility, that the expenditure was of a defensive kind, rather than made to acquire an asset. This distinction is comparable with that between insuring against loss of capital, at however great a cost, and acquiring capital: Australian National Hotels Ltd. v. Federal Commissioner of Taxation (1988) 81 ALR 667 at 674.*

Pincus J's reference to claiming deductions for the cost of insuring capital assets against loss is highly relevant because it is readily accepted that insurance premiums are revenue in nature despite the fact that they protect the existing value of income earning assets. However, despite Pincus J's acceptance that expenses incurred to defend an existing position are more likely to be deductible where compared with expenses incurred to acquire an asset it is submitted that he may have inappropriately classified the expenses incurred in the Broken Hill Theatres case as being defensive in nature, where he stated:

> *In Broken Hill Theatres Pty. Ltd. v. Federal Commissioner of Taxation [1952] HCA 75; (1951-52) 85 CLR 423, where the expenditure in question was essentially defensive, it was nevertheless held not to be deductible by Williams J.*

The definition of "defend" includes driving an attacker away[97] and so for a taxpayer to incur defensive expenses their position must be under attack. Broken Hill Theatres was a well-established and dominant player in the theatre market in Broken Hill and accordingly it enjoyed the luxury of acting in a predatory manner stalking its much smaller prey. By means of objecting to new theatre license applications it could stop any potential encroachment on its territory before it commenced.

It is said that attack is the best form of defence as success may rest on the ability to destroy an enemy's ability to attack. In this respect Pincus J is correct in stating that the actions of Broken Hill were a form of defence but it is submitted that these action should be more correctly described as offensive actions incurred to prevent new entrants from attacking. Objectively, the actions of Broken Hill Theatres should be seen as the actions of an existing dominant player undertaken to prevent new entrants from attacking an established market position. Accordingly, they were not incurred in the accepted sense of defending an existing income earning position from an actual attack.

In Pincus J's defence he made reference to one of the other bases on which the High Court in Broken Hill Theatres concluded that the expenses were capital in nature, which was:

---

[94] [1953] HCA 32.
[95] At page 527.
[96] [1990] FCA 436.
[97] The Merriam-Webster online dictionary.

> … *"the purpose of the expenditure by the taxpayer was to secure for itself freedom from further competition in the locality where it carried on business".*

In other words his arguable classification of the expenses as being defensive in nature Pincus J considered that the dominant reason for the denial of deductions in Broken Hill Theatres was because of the expenses were incurred to limit competition and were capital in nature.

Pincus J, in his decision in FCT v Consolidated Fertilizers Ltd[98] made reference to the case of FCT v Snowden and Willson Pty. Ltd.[99] where the High Court considered that costs incurred in defending the taxpayer's reputation before a Royal Commission were deductible even though the expenditure could not be considered to be recurrent. Pincus J when discussing Snowden and Willson made further reference to the concept of expenses incurred to defend a position:

> *The Commissioner's counsel relied upon the Broken Hill Theatres case amongst others, but Taylor J. said that case was one in which "the purpose of the expenditure by the taxpayer was to secure for itself freedom from further competition in the locality where it carried on business". The distinction between acquisition and defence of business advantages recurs.*

In other words expenses incurred to truly defend an existing position[100] from attach are more likely to be deductible whereas expenses incurred to make hostile advances on potential competitors or where market power is used to prevent other parties from attacking a position of existing power are unlikely to be considered to be deductible. Accordingly, expenses incurred to claim assessable and non-assessable compensation amounts should be deductible to the extent that the expenses are incurred to defend the current income earning activity or asset and to maintain an entity's existing economic position.[101]

Non-deductible litigation costs

If litigation costs are incurred to reduce competition and as a result are not deductible is it possible to include them in the cost base of an asset in accordance with Division 110 ITAA 97? Whether the expenses can be included in a cost base will depend on whether the costs fall within one of the five elements of the cost base in that Division.[102] If there exists no relevant asset or CGT event then the costs cannot form part of any cost base and consideration of whether the expenses may be deductible under s 40-880 ITAA 97[103] over a period of five years should be undertaken.

Conclusion

This article has evaluated the ability of payers of compensation amounts to claim deductions for the compensation paid as well as any related litigation costs in addition to the ability of taxpayers claiming compensation to claim deductions for their litigation costs.

---

[98] [1991] FCA 349. The actual decision of the Full Court (Davies, Spender and Lee JJ on 6th August 1991) in the case was that the majority of the Full Federal Court allowed a deduction for expenditure incurred in litigation to prevent the disclosure of confidential information, and thereby protect valuable trade secrets.

[99] [1958] HCA 23; (1958) 99 CLR 431.

[100] Re Pech and FCT (2001) 47 ATR 1215, Magna Alloys & Research Pty Ltd v FCT (1980) 11 ATR 276 and AAT Case 11,608 (1997) 34 ATR 1230 but contrast AAT Case [2013] AATA 783 where the AAT denied a deduction for expenditure to re-enter the financial services industry and the taxpayer was not employed in the industry at the time that the expenses were incurred.

[101] Compensation agreements entered into under the Petroleum and Gas (Production and Safety) Act 2004 are primarily designed to compensate landowners for the impact of the mining activities on their land. In addition to the receipt of assessable and non-assessable compensation these agreements also ensure that the activities are carried on in a manner that limits the permanent damage to the land and of course if permanent damage to the land is minimised then there will be a reduced impact on the current and future income earning capacity of the land.

[102] To be included in the cost base they must relate to acquiring the impacted asset (element 1), are incidental costs (element 2), are costs of owning the asset (element 3), the costs were incurred to increase or preserve the asset or relate to installing or moving the asset (element 4) and the costs were incurred to establish, defend or preserve the asset (element 5).

[103] Section 40-880 ITAA97 allows a taxpayer a deduction for business related costs if those costs are not otherwise taken into account.

The analysis in this article concludes that an immediate deduction is generally available for compensation paid as well as litigation and negotiation costs incurred where the cause of the compensation claim has arisen from the ordinary income earning activities of the payer. This will be the case even where no assessable income is directly produced as a result of incurring the expenses. By contrast where the compensation paid relates to a future period then it is appropriate that a consideration of whether the pre-paid compensation brings into existence an asset of enduring benefit and if such an asset is a depreciating asset the related costs can be expensed over the effective life of that asset.

Litigation expenses incurred by a person seeking compensation will be deductible to the extent that the compensation (if received) would be included in assessable income. Where the compensation is not assessable and/or relates to permanent damage to assets the Commissioner of Taxation considers in many cases that the expenses incurred in claiming the compensation are capital in nature and non-deductible. This article asserts that the Commissioner's current preference towards allowing deductions to payers of compensation is not warranted and that a more equitable treatment should be extended to taxpayers incurring expenses to maintain their existing income earning capacity.

Evidence is provided to demonstrate that in denying deductions to maintain an existing income earing position the Commissioner's is not appropriately interpreting case law in all circumstances. This article submits that the Commissioner in making his evaluation of deductibility for expenses incurred to maintain an existing income earning position should distinguish between true defensive expenditure and expenditure that has the effect of preventing competition. The Commissioner's current approach to denying true defensive expenditure may indirectly aid taxpayers with dominant economic power at the expense of taxpayers with substantially less economic power. Accordingly, the Commissioner needs to adopt a more correct interpretation of the law because his current approach has the potential to stymie competition and support the adage that "might is always right".