Tax deductions in a changing world: Policy options for dealing with the costs of tax advice

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ABSTRACT

The Australian income tax provisions currently permit a deduction for various items of tax-related expenditure, including expenses incurred in managing tax affairs, interest charged by the Australian Taxation Office and the costs of tax litigation. The history of this provision suggests that it was introduced with the principal objective of fostering improved tax compliance, although there are now suggestions that it may be more closely associated with tax minimisation than tax compliance. As a result there have been recent calls for the deduction to be capped at a relatively low level.

This article explores the development of the deductibility of tax-related expenses and compares and contrasts the Australian experience with that of broadly similar tax jurisdictions. It identifies a continuum of approaches that have been adopted elsewhere and suggests that the Australian experience places it at the more generous end of the spectrum.

I. INTRODUCTION

The Australian income tax provisions currently permit an income tax deduction for various items of tax-related expenditure. These include expenses incurred in managing one's own tax affairs, in complying with a legal obligation in relation to another entity's tax affairs, the general interest charge (GIC) and the shortfall interest charge (SIC), and the costs of tax litigation.[1] This specific statutory deduction (which applies in addition to the general deduction provisions contained elsewhere in the income tax laws[2]) was introduced in 1963 with the principal objective of fostering improved tax compliance through increased use of registered tax agents, one of the recommendations of the Ligertwood Committee which had reported two years earlier.[3]

More recently, however, there have been concerns expressed in some quarters that the deduction for tax-related expenditure is being manipulated by some of Australia's highest earners and wealthiest individuals, and as a result is being used as a mechanism for paying no or little tax.[4] Rather than operating as a tax compliance measure, it is suggested that the deduction is being used as a tax mitigation strategy.

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[1] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) s 25-5; formerly *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) s 69 and s 51(5).

[2] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) s 8-1(1); formerly *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) s 51(1).

[3] Commonwealth Committee of Taxation (Sir George Ligertwood, chair), *Report of the Commonwealth Committee of Taxation* (Government Printer, June 1961) (Ligertwood Report).

[4] Peter Martin, "Tax Office Statistics reveal the 55 millionaires who paid no tax", *The Sydney Morning Herald* (30 April 2015); Peter Martin, "Meet the 56 millionaires who pay next to no income tax", *The Sydney Morning*

The number of taxpayers and the sums involved are not trivial. *Taxation Statistics* shows that over 6 million taxpayers (or roughly half of those submitting a tax return) claim deductions for tax-related expenses (currently Item D10 in the personal tax return).[5] The overall amount claimed under this particular item in the tax return was well over $2 billion in the year ended 30 June 2015, compared to just over $37 million in the 1979 fiscal year (the first year for which statistics on this matter are available).[6] The average (mean) amount claimed was relatively low at only $378 in 2015, but the median figure for that year ($165) indicates that a small minority are claiming considerably larger amounts than the average.[7] Indeed, it is noted that while the average for all people submitting a tax return in 2015 was just $378, it was considerably more for high income earners – up to $12,657 on average for those earning more than 1 million dollars a year,[8] with 48 individuals allegedly claiming more than 1 million dollars under this line item in the 2015 tax return.[9]

In response to such concerns, the Australian Labor Party (ALP), currently in opposition, has proposed a $3,000 cap on the deduction individuals can claim for managing their tax affairs.[10] This proposed new cap would apply from 1 July 2019 and would affect individuals and other business-like structures such as trusts and partnerships that are taxed as individuals, and not companies. A carve-out would be included for individual small businesses with positive business income and annual turnover up to $2 million. The ALP's estimate of the revenue gain from the policy is $1.3 billion over the medium term.[11] Although the ALP has suggested the measure would only affect a small percentage (less than 1 per cent or approximately 90,000 in total) of taxpayers, the immediate reaction of the tax profession was one of dismay and no little concern.[12] The current Federal government has not commented directly on the proposal, but it would seem unlikely to support such a restriction on the costs of managing tax affairs.

Herald (22 March 2016); Peter Martin, "Meet the 48 millionaires who pay no income tax, not even the Medicare levy", *The Sydney Morning Herald* (19 April 2017). See also Matt Grudnoff, "Paying for zero: The impacts of limiting the deduction for managing your tax affairs to $3,000", The Australia Institute (May 2017).

[5] Australian Taxation Office, *Taxation Statistics 2015-16* (Commonwealth of Australia). Note that in November 2017 the ATO indicated that it would – with effect from the 2018 tax return – split the costs of managing tax affairs deduction label on the 2018 individual tax return into the following three sub-components: interest charged by the ATO; litigation costs; and other expenses incurred in managing your tax affairs: Australian Taxation Office, "Changes to how you claim the cost of managing tax affairs" (22 November 2017), https://www.ato.gov.au/Tax-professionals/TP/Changes-to-how-you-claim-the-cost-of-managing-tax-affairs/.

[6] Australian Taxation Office, *Taxation Statistics 2015-16*, n 5.

[7] Grudnoff, n 4, at 1.

[8] Grudnoff, n 4, at 2.

[9] Martin (2017), n 4.

[10] Chris Bowen, *Fairer Tax System*, Media Release from the Shadow Treasurer (11 May 2017). The proposal was first mentioned in the Budget-In-Reply speech in the House of Representatives by the ALP Leader, the Hon Bill Shorten, on 11 May 2017.

[11] Budget reply speech, p 4448. Note also that on 19 November 2018 the Opposition ALP announced a further policy initiative involving the proposed establishment of tax clinics, modelled on the longstanding comparable US program, to assist and advise low income taxpayers in resolving disputes with the ATO, involving an estimated expenditure of $4 million over four years (though not described as a direct reallocation of savings from the reform of the managing tax affairs deduction): see, eg, Nassim Khadem, "Vulnerable taxpayers would get free legal advice under Labor 'tax clinic' plan", *ABC News* online (19 November 2018), https://www.abc.net.au/news/2018-11-19/vulnerable-taxpayers-would-get-free-legal-advice-under-labor/10505940. On the US program, see Taxpayer Advocate Service, "Low Income Taxpayer Clinics", https://taxpayeradvocate.irs.gov/about/litc.

[12] See, for example, Michael Croker, "Labor's proposed cap on deductible tax agent fees - some issues to think about" (2017) 37 *Weekly Tax Bulletin* [1274] (1 September).

It appears, therefore, that the deductibility or otherwise of tax-related expenses may prove to be a contentious, albeit relatively minor, part of the tax debate in future Federal elections. The debate is also inevitably influenced by perceptions, justifiable or not in any particular instance, used to argue for or against the deduction: for example, on the one hand, that it is needed to assist in the protection of taxpayers' rights in being able to pursue legitimate disputes with a much larger revenue authority, is a necessary consequence of complexity in the tax system that taxpayers and their advisers did not create, and is needed for individual taxpayers on horizontal equity grounds given that corporate taxpayers will often have access to such deductions through other deduction provisions (either legitimately or through practical problems with the enforcement of such other provisions); and on the other that it is a provision which is being heavily utilised by the wealthy, promotes tax avoidance and is merely a concession (or "tax expenditure", though not currently reported in Treasury's annual Tax Expenditures Statement) that cannot be justified on tax policy grounds.

Given this contention over the deduction, and the sums involved, it is useful to consider how the provision for the deduction of tax-related expenses came about in Australia more than half a century ago, how it has changed since then, and how other, broadly comparable, tax jurisdictions deal with the deductibility of such expenditure. Such an analysis, which is the purpose of this article, can provide a platform from which meaningful conclusions about the current law and its application can be drawn and sensibly inform the debate about the future of the provision. It is not the purpose of this article to consider – from a policy perspective – the likely effectiveness or ineffectiveness of the ALP or other proposals for change: that will be the subject of a future article. Rather, it is to provide a thorough technical analysis of the development and current status of the Section 25-5 deduction within the context of how other Anglo-centric countries have tackled the same or similar issues. Hence reference is made to the position in countries such as Canada, Hong Kong, New Zealand, South Africa, the United Kingdom (UK) and the United States of America (US) as part of this comparative analysis.

The remainder of this article is structured as follows. Section II traces the history of Australian legislative provisions and relevant case law on the development of the law on deductibility, including tax-related expenses, in the period up to the 1960s. This is followed by an examination of the recommendations in the Ligertwood Report and the enactment of the specific provision for the deduction of tax-related expenses in that decade, together with subsequent developments in Australia through to the current position. Section III comprises a comparative legal analysis, highlighting the similarities and differences in developments in other comparable tax jurisdictions; namely, the US, Canada, New Zealand, the UK, Hong Kong and South Africa. The final section draws the analysis together, and makes some concluding comments and suggestions for future research.

II. AUSTRALIAN HISTORICAL CONTEXT

A Tax-related expenses and the development of the law on deductibility

Prior to the 1960s there was no specific provision in Australia that dealt with the deduction of tax-related expenses. Rather, such expenditure fell to be dealt with under the extant provisions for general deductions, dependent upon whether the taxpayer concerned was in business or was an individual not in business.

Within this broader context of the more general deduction provisions, professional fees such as legal costs and accounting and audit expenses have played an important part in the

development of tax law in Australia on key issues relating to deductibility. By 1950, the High Court had reached a wide view in the *Green* case in relation to whether book-keeping and audit fees in general would meet the test of being incurred in "gaining or producing [the taxpayer's] assessable income"[13] and whether there would a sufficient degree of continuity of a business-related activity to give rise to this connection.[14] In this decision, however, the Court expressly stated that it was not deciding the question of deductibility of tax-related expenses.[15]

Important general principles of deductibility on quite similar types of expenses, however, were laid down by the High Court in cases in 1932 and 1958, allowing business deductions for damages and settlements paid by a taxpayer publisher in libel suits (*Herald and Weekly Times*) and legal expenses incurred by a taxpayer in representation at a Royal Commission (*Snowden and Willson*).[16] The principles in these cases involved identification of a relevant nexus with the business activity rather than a "cause and effect relationship between the outlay and the production of an identifiable receipt of income…" as had been laid down in UK cases to that point.[17] These tests had nevertheless by the 1980s led to the position that fines and penalties are not deductible in Australia for income tax purposes.

More generally also, legal costs relating to the significant issue of defence of title of a business were at issue in the High Court's further important decision in the field in 1952 (*Broken Hill Theatres*), where the Court reached the settled view that expenses would be categorised as being of a revenue nature if related to the "income-earning process" of the business but of a capital nature if related to the "income-earning structure".[18] The latter expenses of a capital nature are left to find a provision allowing depreciation over time or other provisions such as the "black hole expenditure" rules to make deduction possible[19] (or may otherwise be able to be added to the cost base of an asset involved in a capital transaction).

While these broader Australian principles were in development, a stricter position in relation to deductibility of professional expenses relating to determining tax payable or contesting a dispute with the revenue authority had already been reached in a UK case by the House of Lords in 1948. The key decision in *Smith's Potato Estates* found that legal and accounting costs in disputing an assessment to the then Excess Profits Tax were excluded from deductibility as expenses which were "not … wholly and exclusively laid out or expended for the purposes of the trade" of the taxpayer business under the statutory provisions, i.e., the costs

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[13] *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) s 8-1(1); formerly *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) s 51(1).
[14] *Federal Commissioner of Taxation v Green* (1950) 81 CLR 313.
[15] *Federal Commissioner of Taxation v Green* (1950) 81 CLR 313 at 319.
[16] *Herald & Weekly Times Ltd v Federal Commissioner of Taxation* (1932) 48 CLR 113; *Federal Commissioner of Taxation v Snowden & Willson Pty Ltd* (1958) 99 CLR 431.
[17] Richard Krever, "The Deductibility of Fines: Considerations from Law and Policy Perspectives" (1984) 13(3) *Australian Tax Review* 168, 170-171, noting in particular the 1906 UK decision of *Strong & Co. v Woodifield* [1906] AC 448.
[18] *Broken Hill Theatres Pty Ltd v Federal Commissioner of Taxation* (1952) 85 CLR 423; the test had been put forward in 1938 by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd v Federal Commissioner of Taxation* (1938) 61 CLR 337 at 359-364. On the development of this legal test, see Richard Krever and Peter Mellor, "Legal Interpretation of Tax Law: Australia" in Robert F van Brederode and Richard Krever (eds) *Legal Interpretation of Tax Law* (Kluwer, 2nd ed, 2017) 15, 26-27. The Australian approach to preservation of asset expenses as capital in nature has however been criticised in comparison with the broader UK approach generally treating such expenses as being of a revenue nature: Richard Krever, "Capital or Current: The Tax Treatment of Expenditures to Preserve a Taxpayer's Title or Interest in Assets" (1986) 12(2) *Monash University Law Review* 49, 66-67.
[19] ITAA 1997 Div 40.

involved "expenditure incurred for tax purposes and nothing else".[20] An element of the reasoning of two members of the majority in the *Smith's Potato Estates* case also was that tax-related expenditure should not be allowed as a deduction in determining taxable profit because the amount of income tax itself was not taken into account in determining the amount of taxable profit (ie, in effect, income tax was applied to taxable profit on a "tax inclusive" basis):

> …neither the cost of ascertaining taxable profit nor the cost of disputing it with the Revenue authorities is money spent to enable the trader to earn profit in his trade. What profit he has earned, he has earned before ever the voice of the tax-gatherer is heard. He would have earned no more and no less if there was no such thing as Income Tax.[21]

The majority in the case[22] also declined to overrule the prior decision in *Strong v Woodifield*.[23]

The UK decision also left a fine distinction to be made in theory at least between accounting costs incurred to generate the trading accounts and "any additional cost of making up Revenue accounts", though the Court noted that the Inland Revenue usually allowed both types of costs "as a matter of convenience".[24]

While, as noted above, the *Green* case had not stated a position on the issue of tax-related expenses in 1950, the Commonwealth Taxation Board of Review nevertheless quickly applied the *Smith's Potato Estates* ruling in Australia in cases in the 1950s and early 1960s. Legal costs incurred by a manufacturing company in contesting New South Wales state income tax

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[20] *Smith's Potato Estates Ltd v Bolland (I of T)* [1948] AC 508; 30 TC 267 at 288 (HL) per Lord Porter. The non-deductibility of tax-related expenses is often seen to follow on from the non-deductibility of amounts of income tax paid themselves under the income tax: *Smith's Potato Estates*, 30 TC 267 at 294-295 per Lord Normand. See also, for example, the discussion in Brian P McMahon and Christopher J Vincent, "Deductibility of Taxation Related Expenditure" (1979) 14 *Taxation in Australia* 342, 345, referring also (at 342) to the decision in *Davies Coop & Co Pty Ltd v Commonwealth* (1935) 54 CLR 155 that company tax payments could not be taken into account in determining "net profits" under legislation providing for a cotton industry bounty. On the feasibility of making income tax payments deductible, see also more recently Bill Butcher and Ewen McCann, "The Market Based Capital Revenue Boundary and Income Tax Payments" (2008) 23(4) *Australian Tax Forum* 359.

[21] *Smith's Potato Estates Ltd v Bolland (I of T)* [1948] AC 508; 30 TC 267 at 293 per Lord Simonds; similarly, per Lord Normand at 294-295. As noted further in the discussion on US developments below, the modern federal income tax as originally imposed in that country in 1913 was initially imposed in a "tax exclusive" form for taxpayers other than corporations, so as to allow deduction of all taxes paid during the year including federal income tax itself. See Lawrence Zelenak *Figuring Out the Tax: Congress, Treasury, and the Design of the Early Modern Income Tax* (Cambridge University Press, 2018) 64-79. However, while amendments to the tax in 1917 removed the deduction for federal income tax, the courts nevertheless quickly established in decisions after 1917 that tax-related expenditure incurred by business taxpayers was deductible, without any apparent impediment from reasoning about tax inclusivity as later adopted in the *Smith's Potato Estates* case in the UK. It is also relevant in this context that early US income tax practice appears to have taken a broad approach of including "professions of all types as well as various avocations and 'side-lines'" in the scope of a trade or business for which expenses were allowable deductions: see R H Montgomery *Income Tax Procedure* (Ronald Press, 1919) 401 (footnote omitted). As a result, it appears that US taxpayers would have had a broadly established understanding of the deductibility of tax-related expenditure from the outset of the income tax era.

[22] *Smith's Potato Estates Ltd v Bolland (I of T)* [1948] AC 508; 30 TC 267 at 290 per Lord Porter; at 292 per Lord Simonds; at 295 per Lord Normand.

[23] *Strong & Co. v Woodifield* [1906] AC 448.

[24] *Smith's Potato Estates Ltd v Bolland (I of T)* [1948] AC 508; 30 TC 267 at 288 per Lord Porter. As will be discussed further below, the experience in Canada similarly saw the allowance by the authorities of a deduction for annual accounting fees covering audit and tax services and ongoing legal retainers covering advice on a range of different tax and non-tax matters. In relation to legal retainers at least, Australian administrative practice also appears to have been for the revenue to allow deduction for "annual retainers paid by a business to its legal advisers without generally seeking particulars of the actual services performed and fees attributable thereto": McMahon and Vincent, n 20, 345-346.

in Board proceedings were found not deductible under the Commonwealth income tax in December 1951;[25] tax consultant and accountant fees paid by a company to profit averaging for taxation of income from sales of livestock were found not to be incurred in gaining or producing assessable income in 1956;[26] legal and accounting fees incurred by a medical practitioner in making income tax calculations required for a tax office investigation were similarly denied deductibility in 1962,[27] and accounting fees relating to dispute as to the tax on sale of land were also found not to meet the test in October 1963.[28] Conversely, in one Board of Review decision a business taxpayer apparently found success in relation to deductibility of tax-related costs,[29] but this appears to have been an isolated case.

Following on from these developments, an important finding was also made by the Supreme Court of Canada in 1966 (after statutory interventions had begun to be made in the field in that country and Australia) in relation to professional legal fees incurred in disputing a tax assessment issued by a foreign country in the *Premium Iron Ores* case. The majority found that such expenses simply were characterised as costs in resisting a third party claim in "an attempt to protect Canadian income".[30] As a result, the *Smith's Potato Estates* decision was distinguished by the Canadian Court, and the expense was also found "not to be an outlay or replacement of capital, nor a payment on account of capital" but to be an expenditure to defend "a claim which, if established, would have created a liability in relation to [the taxpayer's] income".[31]

Commentary on this decision at the time noted that the ruling did not add much clarity to the law on where to draw the line between revenue and capital expenses in general in the case of legal costs, but that the findings in relation to deductibility of expenses to contest a foreign tax dispute were more significant, and more promisingly that the comments of Justice Hall appearing to disagree with the strict view that tax calculation was outside the scope of deductibility may have been taken to "portend things to come".[32]

This Canadian decision did not receive any consideration in the Australian courts until 1985, in the *Cliffs International* case,[33] involving professional costs relating to a dispute over exempt income. The Supreme Court of Western Australia there however ultimately took a strict view of the *Premium Iron Ores* decision, deciding that it was relevant only to the question of deductibility of fees for contesting foreign taxes. As a result, in relation to the fees relating to exempt income in Australia, the Canadian decision was seen as "not diminishing in any respect the weight of the House of Lords decision" and the differences in wording between the UK and

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[25] *Case 32*, 2 CTBR (NS) 148 (7 December 1951).
[26] *Case H12*, 8 TBRD 51 (3 August 1956).
[27] *Case N9*, 13 TBRD 28 (28 August 1962).
[28] *Case P22*, 14 TBRD 103 (29 October 1963).
[29] *Case 56A*, 10 CTBR (original series) 167, referred to in the Ligertwood Report, n 3, [115]. A copy of this case could not be located by the authors.
[30] *Premium Iron Ores Ltd v Minister of National Revenue*, [1966] SCR 685 at 705 per Martland J, Spence J agreeing. Hall J (at 711) agreed with this conclusion and appears to have gone further in questioning the applicability of the UK decision in relation to legal expenses in general under the broader wording of the then Canadian *Income Tax Act* of expenses "made or incurred for the purpose of gaining or producing income from property or a business" and suggested that an attempt to make a strict distinction between "revenue producing as distinct from revenue retaining functions" would lead to "a condition of chaos".
[31] *Premium Iron Ores Ltd v Minister of National Revenue*, [1966] SCR 685 at 705 per Martland J.
[32] W J A Mitchell, "Deductibility Revisited" (1969) 4(1) *UBC Law Review* 147 at 149; this article was noted in Anthony P Molloy, *Molloy on Income Tax* (Butterworths, 1976) [929] n 1, discussing the application of the *Smith's Potato Estates* case in New Zealand prior to enactment of the statutory provision there in 1972.
[33] *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601.

Australian business deduction provisions "[did] not require a different answer" to that reached by the House of Lords.[34]

In any event, during the 1950s in Australia, the non-deductibility of tax-related expenses was causing pressure to build for statutory intervention in the field.

B Ligertwood Committee recommendations in 1961 and enactment of the statutory deduction

The Menzies coalition government took a cautious position in its policy announcements in October 1958 for the federal election set for 22 November that year. While under an "Australia Unlimited" banner, specific spending promises were downplayed in favour of a general pitch to provide economic benefits for the electorate in the longer run as conditions improved, with a number of special conferences to be held to move the process along.[35] One of these was to be an "independent public investigation into tax laws" which became the Ligertwood Review ultimately appointed in December 1959.[36]

When the Ligertwood Report was tabled in August 1961, most of the attention focused on the recommendation to enact new laws to deal with "large-scale" tax evasion mainly in the categories of companies, family partnerships and trusts, superannuation funds and leases said to be causing annual revenue losses of at least £14 million.[37] However, the Report had also made some examination of the area of deductions. It was noted at the outset that support for many proposals in this area "was claimed to be found inter alia in the income tax legislation of overseas countries such as the United States and Canada", though the Committee considered that the position in such countries was "sometimes misunderstood".[38] On the issue of deductions for tax-related expenditure, the Committee noted the decisions in *Case 56A* and *Green* and took the view that "it is to the advantage of both the taxpayer and the revenue authorities for returns to be prepared by registered tax agents".[39] Accordingly, "[t]he Committee recommends that a deduction should be allowed in respect of fees paid by a taxpayer, to a registered tax agent, for the preparation of that taxpayer's income tax return".[40]

This recommendation was ultimately adopted in the government's Budget announcement in August 1963,[41] in the lead-up to the federal election held on 30 November of that year. The

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[34] *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601 at 628.

[35] "Concessions Later Says Mr Menzies; No 'Lush' Promises in Election Policy Speech", *Canberra Times* (30 October 1958) 1.

[36] "Tax Committee To Be Announced Soon", *Canberra Times* (15 October 1959) 3; "Taxation Inquiry Committee Details Revealed", *Canberra Times* (4 December 1959) 3.

[37] "Clamp-Down On 'Exploiters'; New Laws To Stop Tax Loss of £14M", *Canberra Times* (18 August 1961) 1, 3.

[38] Ligertwood Report, n 3, 21-22.

[39] Ligertwood Report, n 3, 25-26.

[40] Ligertwood Report, n 3, 26.

[41] Commonwealth, Budget Statement No 3: Consolidated Revenue Fund Estimates, 1963-64, Addendum – Revenue Proposals, General Business Deductions, referred to in Commonwealth Parliamentary Debates, House of Representatives, 13 August 1963. The recommendation was also adopted to allow a general deduction for legal expenses incurred by businesses for the purpose of gaining or producing assessable income without application of the exclusion where the expenses were of a capital nature, up to a maximum of £25, as new s 64A of ITAA 1936 (which continued with a $50 limit until 1997 when it was discontinued in the ITAA 1936 and not carried to the ITAA 1997 under the Tax Law Improvement Project and ultimately repealed in 2006). This recommendation had been made in the Ligertwood Report shortly after the consideration of the interaction of the main deductibility tests and the exclusion for capital expenses in *John Fairfax and Sons v Federal Commissioner of Taxation* (1959)

deduction for fees paid to a tax agent in preparation of a return did not seem to register specifically in media coverage of the policy announcements (education allowances and removal of the medical expenses deduction cap being the prominent items, the tax agent deduction apparently part of the sweep-up reference to "minor tax concessions for businessmen"),[42] but was enacted into law with little debate as new section 69 of ITAA 1936 on 31 October 1963.[43]

C The expansion of the statutory deduction post 1963

The scope of the deduction for tax-related expenses as enacted in 1963 was very restrictive (applying only to the tax return preparation fees paid to a registered tax agent). The available statistics for this era do not provide many specific details on how quickly the deduction began to be taken up in terms of its evolution from that introduction to the very major tax expenditure it represents today.[44] Nonetheless, it is clear from those statistics that reliance on the original section 69 statutory deduction grew rapidly in the decades after its enactment.[45] In part this reflected an expansion in the scope of the statutory deduction in the period after 1963, a theme which is explored later in this section.

Notwithstanding this expansion in the scope and the utilisation of the specific deduction provision, both business and personal taxpayers were more generally making little progress in achieving an expansion of the tests for deductibility of other tax-related expenses under the general law. In particular, a Board of Review application fee was found not deductible in 1974,[46] legal expenses relating to an income tax appeal by a business taxpayer were found not deductible in 1985[47] and legal expenses incurred by a dentist in preparation of a notice of objection which was ultimately allowed and led to payment of assessable interest on overpaid tax were found not deductible in 1989.[48]

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101 CLR 30, where legal expenses were held not deductible as outgoings of a capital nature: see discussion of this case in J H Momsen, "Tax-Related Expenses" (1990) 2(1) *CCH Journal of Australian Taxation* 53, 54.

[42] "Budget Gives Family Man Concessions; Sales Tax Off Food, Pensions Increased", *Canberra Times* (14 August 1963) 1; "1963/64 Budget Details: Taxes Cut By £27.6M In A Year", *Canberra Times* (14 August 1963) 9.

[43] *Income Tax and Social Services Contribution Assessment Act (No 2) 1963* (Cth) s 20. The former section 69 related to deductions for felled timber included in the ITAA 1936 as originally enacted had previously been repealed by the *Income Tax and Social Services Contribution Assessment Act (No 3) 1956* (Cth) s 10.

[44] See, for example, Commonwealth, *Report of the Commissioner of Taxation*, 1963-64 – 1968-69. It is also notable that the number of registered tax agents also increased disproportionately in the period after 1963, from just over 12,000 in March 1963 to just under 20,000 by March 1974: Commonwealth, *Report of the Commissioner of Taxation*, 1951-52 – 1973-74.

[45] *Taxation Statistics 2015-16*, n 5.

[46] *Case F50*, 74 ATC 276. The taxpayer in that case was a part-time lecturer in business law and also ran a small accountancy practice and the other claims in the case involved certain nursing expenses for a child dependant, car expenses and depreciation and a part of costs attributable to a home office. Only the claim for car depreciation succeeded. The argument that the fee was incurred for commencing Board proceedings (generally conducted in private under the relevant Regulations) which would enhance the taxpayer's knowledge of tax procedures relevant to his income-earning activities was held not to alter the character of the fee as an expense which could only provide a possibility of reducing an existing liability or gaining a refund of tax already paid.

[47] *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601; n 33 above.

[48] *Federal Commissioner of Taxation v Ryder* (1989) 20 ATR 443 (29 March 1989). This decision and others in the field of tax-related expenses have recently been discussed in the broader context of ongoing issues of deductibility of regulatory and compliance costs in New Zealand and Australia: see Julie Harrison and Mark Keating, "The Deductibility of Sarbanes-Oxley Costs Incurred by Australasian Companies" (2014) 27(1) *Journal of Accounting Research* 52.

The latter two decisions were also important for occurring in a period of broader change to the income tax in Australia, from new substantiation requirements and self-assessment for individual taxpayers in 1986 to self-assessment also for companies and superannuation funds in 1989, with further administrative changes subsequently such as electronic lodgement for registered tax agents in 1992.[49] The Hawke government's Budget of 15 August 1989 thus included an announcement that the existing section 69 provision would be replaced with a much broader rule for deductibility of expenditure relating to management of tax affairs. This was made law in early 1990 as part of the move to company self-assessment,[50] as one of the final statutes to be enacted before the March 1990 federal election.

The new section 69 enacted in 1990 now allowed deduction of expenditure (other than expenditure of a capital nature) in respect of a relevantly defined tax-related matter, including "the management or administration of the income tax affairs of the taxpayer" other than offence-related matters. A "tax-related matter" was also defined to include compliance with specified obligations relating to the income tax affairs of another taxpayer. Fees for professional advice qualifying for deductibility were restricted to those for advice provided by a recognised professional tax adviser.

The capital expenditure exclusion was maintained, but it was provided that expenditure was not to be taken to be of a capital nature only because the income tax affairs in question related to matters of a capital nature.

The Explanatory Memorandum to the Bill confirmed the wide nature of the subject area of expenditure that would be deductible:

> Allowable expenditure will include fees paid by a taxpayer to a registered tax agent (or a person exempt from registration) for professional advice in relation to the income tax affairs of the taxpayer, costs associated with disputing an assessment or determination made by the Commissioner, expenditure incurred in attending to an ATO audit and costs associated with tax planning.[51]

Commentary at the time also highlighted features of the provisions suggesting a broad scope for the deduction,[52] and that it was "understood that the ATO is sympathetic toward applying a liberal interpretation in the application of sec. 69 – largely as an acceptance of the quid pro quo of having tax laws that are so difficult in the first place".[53]

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[49] Australian Treasury, *Report on Aspects of Income Tax Self Assessment* (Canberra, August 2004) 1-2; Kylie McKinstry and Jonathan Baldry, "Explaining The Growth In Usage Of Tax Agents By Australian Personal Income Taxpayers" (1997) 13(1) *Australian Tax Forum* 135, 137, also citing J C Baldry, "Personal Income Tax Deductions in Australia, 1978/79-1990/91" (1994) 70(211) *Economic Record* 424, 424, 433 that use of tax agents had by that time become "the norm".

[50] *Taxation Laws Amendment Act (No 5) 1989* (Cth), Assent 17 January 1990, s 8. This was expressed as giving effect to an announcement in the 1989-90 Budget delivered on 15 August 1989: Explanatory Memorandum to Taxation Laws Amendment Bill (No 5) 1989, 11. The provision initially entered Parliament however as a Private Members Bill before being adopted by the government: *Bartlett v Federal Commissioner of Taxation; Falcetta v Federal Commissioner of Taxation* (2003) 54 ATR 261 [57] (Hill J).

[51] Explanatory Memorandum to Taxation Laws Amendment Bill (No 5) 1989, 12.

[52] W J Millar, "Section 69: Tax and Syntax" (1991) 25(9) *Taxation in Australia* 687.

[53] Tony Sloan, "Deductibility: Transactional Tax Advice" (1995) 3(3) *The Tax Specialist* 123, 127. This was referred to particularly in relation to any potential uncertainty in the scope of the provision referred to above ensuring that expenditure would not be found to be of a capital nature only because it related to income tax affairs of a capital nature.

The expanded deduction provision introduced in 1990 was transferred into the *Income Tax Assessment Act 1997* (ITAA 1997) in a rewritten form as new section 25-5 under the *Tax Law Improvement Act 1997* enacted in July of that year,[54] a process which went smoothly apart from the need for a last minute correction to the Bill to iron out a problem seen at the time as having the potential to substantially limit the saving provision for expenditure relating to tax affairs of a capital nature.[55] A definition of "tax affairs" as "affairs relating to *tax" (as itself relevantly defined as income tax imposed under the Income Tax Act 1986 or another Act and assessed under the ITAA 1997) was added in 1999.[56]

While individual deductions under this provision were growing at a steady annual rate, a favourable interpretation of the provision was also enunciated by the Federal Court in October 2003 on the question of the relevant tax affairs that could give rise to the deduction.[57] The expenses in this case related to advice given to clients both in relation to their personal affairs and also in relation to matters associated with their roles as director, shareholder or public officer of certain companies, including group tax and liquidation issues. The Court confirmed that the "tax affairs" covered by the provision included such matters relating to obligations following on from the company's tax liabilities, in keeping with the scope of the section 69 provision substituted in 1990.[58]

The Full Court also rejected submissions on appeal that a deduction was not available in relation to expenditure by directors relevantly relating to guarantees given over the liabilities of the company for which they were then personally liable as expenditure of a capital nature, as the expenditure was incurred in relation to both the taxpayers' own tax affairs and those of the company.[59]

It has subsequently been noted that these decisions provide important indications about the availability of deduction for expenditure by company directors (and possibly even shareholders) on compliance-related matters given the effect of section 8Y of the *Taxation Administration Act 1953* deeming relevant persons concerned in the management of a company to commit offences where an act or omission of the company constitutes a taxation offence.[60] It would also be necessary in such a case, however, to consider the application of the exclusion of expenditure relating to "the commission (or possible commission) of an offence against an *Australian law…".[61]

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[54] *Tax Law Improvement Act 1997* (Cth) Sch 1 Item 4.

[55] William Kazaglis, "Tax Law Improvement Bill 1996 (TLIB): Tax-related expenses – s 25-5" (1997) 25 *Weekly Tax Bulletin* [621] (26 May), referring to the original wording of s 25-5(4) that: "You cannot deduct capital expenditure under subsection (1). However, expenditure on matters relating to capital expenditure is not necessarily capital expenditure". The wording "…matters relating to capital expenditure" was seen as too restrictive compared to "…matters of a capital nature".

[56] *A New Tax System (Tax Administration) Act 1999* (Cth) (22 December 1999).

[57] *Bartlett v Federal Commissioner of Taxation; Falcetta v Federal Commissioner of Taxation* (2003) 54 ATR 261; relevant conclusions on this issue upheld in *Falcetta v Federal Commissioner of Taxation; Federal Commissioner of Taxation v Bartlett* (2004) 56 ATR 59 (10 May).

[58] Commentary at the time noted the advantage, "as the tax agent involved [in the case] would seem to have realised", that may follow if directors to incur tax advice expenses rather than a company depending on the financial situation of the company: Graham Taylor, "The deductibility of tax agent fees" (2004) 38(8) *Taxation in Australia* 407, 408-409.

[59] *Falcetta v Federal Commissioner of Taxation; Federal Commissioner of Taxation v Bartlett* (2004) 56 ATR 59 [51]-[52].

[60] Kaylene Hubbard, Matthew Eakin and Phillip Browne, "Section 25-5: More Than Meets the Eye?" (2012) 46(9) *Taxation in Australia* 401.

[61] ITAA 1997 s 25-5(2)(d).

While the government's review of the self-assessment system in December 2004 did not consider the scope of the deduction for managing tax affairs, continued growth in this deduction by individuals of around 10% per year in the early 2000s (and up to 16% in the 2007-08 year itself) eventually brought greater attention to this and other deductions along with the ongoing issue of the extent of usage of tax agents by individuals in Australia more generally.

The wide-ranging Henry Review of 2009 attributed the heavy reliance on tax agents to complexity in the tax laws,[62] and reaffirmed the need for the managing tax affairs deduction as it was "important in recognising the compliance costs imposed by government on individuals" and could be seen as "one of the direct costs of the tax system".[63] A recommendation was made however for introduction of an optional standard deduction in place of the existing provisions for work-related expenses and the managing tax affairs deduction, which was subsequently taken up by the government as a policy announcement in its 2010-11 Budget as part of its broader policy to impose the Minerals Resource Rent Tax.[64]

This proposal was subsequently dropped in the 2012-13 Budget,[65] however, and a further parliamentary inquiry into tax deductibility overall, while providing lengthy consideration of the costs of individual work-related and tax expense deductions, also found that the existing system of deduction in principle was appropriate, and that efforts should be focused on dealing with abuse in claims in order to lower the revenue cost.[66]

It is therefore only the current Labor Opposition's policy of early 2017 to impose a mandatory ceiling on claims by individuals for expenses in managing tax affairs that has directly targeted the increasing revenue costs in this area.[67] It is thought that this trend is largely attributable to claims by a small number of individuals.[68] The policy is also now supported by ongoing research findings that use of tax agents may in many cases be more associated with tax minimisation than ensuring tax compliance in general[69] that would otherwise provide the public benefits in this area originally envisaged.

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[62] Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (Henry Review) Pt 2, Vol 1, 5-6.
[63] Henry Review, n 62, Pt 2, Vol 1, 56.
[64] Australian Treasury, "Making Tax Time Simpler: Standard Deduction for the Cost of Work-Related Expenses and the Costs of Managing Tax Affairs", Discussion Paper (February 2011).
[65] Kai Swoboda, Parliamentary Library, Budget Review 2012-13, "Minerals Resource Rent Tax: changes to revenue and expenditure estimates", 11 May 2012, https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/BudgetReview201213/MRRT.
[66] Parliament, House of Representatives Standing Committee on Economics, *Report on the Inquiry into Tax Deductibility* (Canberra, June 2017) 29, 59-60.
[67] Emma Koehn, "Four things we learned from Bill Shorten's 2017 budget reply speech", *smartcompany* (12 May 2017), https://www.smartcompany.com.au/business-advice/politics/budget-2017-four-things-we-learned-from-bill-shortens-2017-budget-reply-speech/.
[68] Michael Janda, "Tax deductions for advice should be capped at $3,000: Australia Institute", *ABC News* online (22 May 2017), http://www.abc.net.au/news/2017-05-22/tax-deductions-for-advice-should-be-capped/8546170.
[69] Eryk Bagshaw, "Flat income tax rate will limit people 'gaming the system': researcher", *Canberra Times* (13 June 2018), https://www.canberratimes.com.au/politics/federal/flat-income-tax-rate-will-limit-people-gaming-the-system-researcher-20180612-p4zkza.html, citing a conference paper by ANU Professor Breunig that flatter rate structure would stop bunching apparently driven in part by Australia's high propensity to use tax agents; see also, Elea Wurth, 'A will and a way: An analysis of tax practitioner preparation compliance' (PhD Thesis, ANU, February 2012).

III. COMPARATIVE ANALYSIS

A Overview: The current Australian approach

The current Australian statutory provision for the deduction of tax-related expenses has evolved from its very restrictive introduction in 1963 – whereby only fees incurred for the preparation of an income tax return by a registered tax agent were deductible – to a far more expansive provision in section 25-5 whereby a deduction may be obtained for a variety of "tax-related expenses" which include expenditure to the extent it is for:

- managing the taxpayer's own tax affairs — this covers, for example, fees paid to a registered tax agent for preparing an income tax return, fees paid to a solicitor or registered tax agent for tax planning advice and costs incurred in disputing an assessment;
- complying with an obligation imposed on the taxpayer by a Commonwealth law, insofar as that obligation relates to the tax affairs of an entity — this covers, for example, the cost of supplying to the Commissioner information and documents concerning the income tax affairs of another entity or satisfying a demand under *Taxation Administration Act 1953* (TAA) Schedule 1 section 260-5 for payment of tax owed by another entity and the cost to an employer of withholding and remitting PAYG amounts;
- the general interest charge (GIC) under TAA Pt IIA Division 1 and the shortfall interest charge (SIC) under TAA Schedule 1 Division 280 on unpaid tax and penalty and underpayments of tax;
- a penalty payable under *A New Tax System (Goods and Services Tax) Act 1999* Subdivision 162-D because varied GST instalments are too low;
- a levy payable under the *Major Bank Levy Act 2017* (TAA Schedule 1 Part 3-15);
- obtaining a valuation in accordance with section 30-212. The valuation is required where the taxpayer makes a gift of property under Division 30 and the value of the property is to be determined by the Commissioner; and
- obtaining a valuation from the Commissioner in accordance with section 31-15. The taxpayer must obtain a valuation of the change in the market value of land which becomes subject to a conservation covenant before the taxpayer can obtain a deduction under section 31-5.[70]

In addition, individual taxpayers – to the extent that section 25-5 does not permit them a deduction for a particular expense related to their tax affairs – may be able to access the general deduction provisions of section 8-1. For example, an individual carrying on a business is entitled to claim under section 8-1 expenditure incurred in connection with the preparation of tax returns (and also the costs of any resulting disputes) for fringe benefits tax, pay-roll tax or land tax. Consultants' fees relating to the implementation of a sales tax minimisation scheme (not deductible under section 25-5(1)) are likely to be deductible under the general provisions of section 8-1.[71] Moreover, on the authority of *Cliffs' case*,[72] the costs of obtaining income tax advice concerning the day-to-day running of a taxpayer's business may be deductible under the general provisions (as well as under section 25-5(1)). Note, however, that there is no restriction in the general provisions, as there is in section 25-5, that in order for fees for income tax advice

[70] Adapted from CCH Australia, *Australian Federal Income Tax Reporter* online [65 080] Tax-Related Expenses (accessed 19 May 2018).
[71] *Jazareed Pty Ltd* v *FC of T* 89 ATC 4459.
[72] Supra, n 32.

to be deductible, the advice must be provided by a "recognised tax adviser".[73] Hence income tax advice not provided by a recognised tax adviser could well prove to be deductible under the general provision even if not allowed under the more specific provision.

This somewhat confused patchwork development of provisions in Australia can be compared and contrasted with the provisions for tax-related expenses that have developed elsewhere in broadly comparable Anglo-centric tax jurisdictions.

As will be shown in the remainder of this section, Australia has not been alone in struggling to find a coherent and sustainable set of principles to apply to the deduction of such expenditure. Indeed, there has been a range of somewhat pragmatic responses, with countries such as the US adopting a relatively broad and liberal approach (at least, that is, until 2017) in contrast to other countries such as the UK where the application of the "wholly and exclusively" test for business taxpayers,[74] and the "wholly, exclusively and necessarily" test for those not in business[75] has led to a much more restricted availability of deductions for tax related expenses. Somewhere towards the middle of the continuum lie jurisdictions such as Canada, Hong Kong, New Zealand and South Africa with restrictive general law rules mitigated to some extent by statutory concessions.

B The broader approach: United States

The broader approach to allowance of substantial deductions to individuals for tax-related expenses is exemplified by the experience in relation to this issue in the US, where it can be seen that a number of key developments parallel and precede the reforms made in Australia that have been set out in the preceding sections of this article.

As noted earlier in this article, while the deduction for income tax itself in the US under the 1913 tax was abolished in 1917, subsequent court decisions quickly established the deductibility of tax-related expenses for business taxpayers on general principles. Individuals also were on occasion able to establish deductibility of legal expenses including tax compliance costs where their personal investment activities constituted a trade or business,[76] until the Supreme Court held against this position in 1941.[77]

This outcome seems to have led to substantial political efforts to provide statutory rules for deductibility of individual legal expenses in 1942 and 1943.[78] At this point, limited provision was also made for individual deduction of certain tax compliance costs through Treasury Regulations, but not however costs relating to matters such as tax return preparation costs and defending claims by the Revenue, and court decisions also continued to take a narrow approach.[79]

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[73] Adapted from CCH Australia, *Australian Federal Income Tax Reporter* online [65 080] Tax-Related Expenses (accessed 19 May 2018).
[74] *Income Tax (Trading and Other Income) Act 2005* s 34.
[75] *Income Tax (Earnings and Pensions) Act 2003* s 336.
[76] Malcolm L Morris, "Determining Deductions Deserves Deductibility" (1993) 21(1) *Florida State University Law Review* 75, 77, referring to court decisions in 1927 and 1938.
[77] *Higgins v Commissioner*, 312 US 212, 217 (1941).
[78] Morris, n 76, 78.
[79] Ibid.

A turn which was to prove important was also taken in 1946 when new Regulations provided a much wider deduction for expenses relating to the determination of a taxpayer's income tax liability and property tax on income-producing property, but excluded expenses for contesting taxes (such as gift tax) merely because an income-producing property might need to be sold to pay such a tax.[80] The validity of this provision itself reached the Supreme Court at an important time politically as the contest for the 1952 presidential election was just getting under way. In the event, the decision confirming the validity of the restrictive regulation was handed down a few days after President Truman's loss in the New Hampshire primary on 11 March 1952, after which he withdrew from the race some 18 days later.[81]

Quickly thereafter Congress went on to re-enact as a whole the income tax statute under the *Internal Revenue Code of 1954*, enacted on 16 August 1954, one of the purposes of which was to sweep away a range of court decisions "favorable to the revenue", such as *Lykes*, "many of which should never have been sought by the Service in the first place".[82] The new Code included section 212(3) providing in very broad terms for deductions for individuals of "all the ordinary and necessary expenses paid … in connection with the determination, collection, or refund of any tax". By way of comparison with Australia, while the expanded US rules were enacted just after Australia's May 1954 federal election and the deductibility issue did not feature in the December 1955 federal election, the issue did enter into the policy position of the Menzies government for the November 1958 election and subsequent appointment of the Ligertwood Committee discussed previously in this article.

In brief, the US provision itself continued to be the subject of litigation at least until the early 1970s,[83] including on the issue of when such expenses would be found to be capital expenditure and so not deductible.[84] By the mid 1980s, however, the expanding cost of the concession began to make it a focus for substantial limitation. The irony has been noted that moves to introduce a limit to the deduction in the 1986 tax reform process were described as being part of that reform effort's "putative call for lowering taxes".[85]

The *Tax Reform Act of 1986* introduced an option for a standard deduction to be taken by individuals in place of specified "itemized deductions". Under the Act, tax-related expenses of individuals came to be included in the "miscellaneous" category of such itemised deductions meaning further that they would only be eligible for separate claim to the extent that the aggregate of the miscellaneous items exceeded 2% of the taxpayer's adjusted gross income, thus setting a *floor* (though not a cap) before individual tax compliance costs could become eligible for deduction. The area of individual tax-related expenses was thus also not one of the various other "sacred cows that were perhaps too dangerous politically to alter" in that reform process.[86]

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[80] Ibid, 79. The 1946 Regulations were issued in response to the Supreme Court decision in *Trust of Bingham v Commissioner*, 325 US 365 (4 June 1945).
[81] Ibid, 81, referring to *Lykes v United States*, 343 US 118 (24 March 1952).
[82] Roswell Magill and Henry W de Kosmian, "The Internal Revenue Code of 1954: Income, Deductions, Gains and Losses" (1954) 68(2) *Harvard Law Review* 201, 206.
[83] Morris, n 76, 82-86.
[84] Ibid; see also George L Bevan, Jr, "Deductible Tax Planning Expenses: The Scope of Internal Revenue Code Section 212-3" (1974) 11(2) *San Diego Law Review* 445, 469-470.
[85] Morris, n 76, 86.
[86] Ibid, 90, noting that it became apparent during the reform process to broaden the base "that a number of deductions were not on the negotiating table", such as the then home mortgage interest and net medical expenses deductions which were amended only slightly. "The local tax deduction section lost some of its value when the state sales tax deduction was eliminated, but efforts to do likewise to state income taxes failed."

This treatment of tax-related expenses was criticised at the time in part for its potential to restore the historical uncertainty in the separation of business and non-business expenses and also for the incentive it provided for "functional" billing procedures to be adopted for individual taxpayers.[87] The failure of the Act to produce simplification overall was also noted, as was an IRS private ruling in 1990-91 which took a strict view on a range of issues relating to the deduction, considered as a result to have "added fuel to the fire" in the area.[88]

In any event, by 2010 the more challenging fiscal position of the US government brought attention to both business and individual deductions of tax-related expenses as areas for elimination in their entirety as an option to raise revenue without the need for a national value-added tax.[89] A proposal for independent floors under each category of itemised deduction was also put forward in 2011 as a means of restoring greater accuracy in applying the progressivity of the tax system.[90]

The *Tax Cuts and Jobs Act* enacted in December 2017 in the tax reform measures introduced into the House of Representatives by the (after the 2018 mid-term elections, outgoing) Republican Party majority, however, achieved a significant further winding back of deductions in this field, at least in the case of individuals. An increase in the standard deduction has been accompanied by the removal in its entirety of the itemised deduction for tax-related expenses, apparently through to tax year 2025 at least.[91] A USD 10,000 cap on deductions for state and local taxes has also been established, though this is said to be "causing some residents to flee for no-tax states like Texas, Nevada, or Florida".[92]

C Intermediate approaches: Canada and New Zealand

The *Smith's Potato Estates* decision in 1948[93] put Canada in much the same position as Australia at this time in terms of non-deductibility of tax-related expenses strictly speaking. In Canada's case, however, in a converse development to that in Australia, concern in this area by the early 1960s seemed to centre more on non-deductibility of costs incurred in disputing tax matters with the authorities than tax return preparation costs themselves. As noted in the *Smith's* case in relation to the UK, it may be that accounting fees in drawing up business tax accounts were also being allowed in Canada as a matter of convenience at that time, though as noted below this certainly had become the case by 1986. Similarly, in terms of individual non-business tax preparation expenses, it may be that the problem of non-deductibility was mitigated by the strictly limited and enumerated form of deductions allowed them under the Canadian Act.

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[87] William T Diss and R Scott Ruby, "Miscellaneous Itemized Deductions Floor Is Bad Policy" (1987) 34 *Tax Notes* 689, 692.
[88] Philip P Storrer, "Deducting Tax-Related Professional Fees" (1991) 51 *Tax Notes* 1575.
[89] Calvin H Johnson, "No Deductions for Tax Planning and Controversy Costs" (2010) 129 *Tax Notes* 333.
[90] John R Brooks II, "Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification" (2011) 2(2) *Columbia Journal of Tax Law* 203.
[91] Darla Mercado, "Grab these breaks on your tax return while you still can", *CNBC* (26 February 2018), https://www.cnbc.com/2018/02/26/grab-these-expiring-tax-breaks-while-you-still-can.html; Robert W Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees" (2018) 158 *Tax Notes* 1387, 1388.
[92] Wood, n 91, 1387.
[93] *Smith's Potato Estates Ltd v Bolland (I of T)* [1948] AC 508; 30 TC 267 (HL).

On the issue of tax dispute costs, however, the Pearson Liberal government acted in 1964, bringing in an income tax amendment Bill to provide a deduction to all taxpayers for "amounts paid … in respect of fees or expenses incurred in preparing, instituting or prosecuting an objection to, or an appeal in relation to, an assessment of tax, interest or penalties under [the federal income tax] Act".[94] In the debate on the measure, Finance Minister Walter L Gordon explained the reasons for the move as follows:

> The purpose of allowing expenses in connection with appeals or objections is essentially to give the smaller taxpayer the same break that most large taxpayers have anyway. In the case of many large taxpayers the fees they pay to the hon. Member for Edmonton West and other tax lawyers, and to the hon. Member for Perth and other tax accountants, are not always broken down and itemized according to each individual service that is performed. Frequently the annual fees that my hon. friend receives as auditor for a company may include an amount which covers all services of this kind and they are allowed as a deduction for tax purposes. Similarly, my legal friends frequently receive retainers which cover a variety of things and for the most part they are allowed as deductions and do not have to be itemized in detail. But if smaller taxpayers, and sometimes a large one, feel they have not been treated fairly by the income tax authorities and want to appeal they may be in a position where they are afraid it will cost them a lot of money in the form of fees … What we are trying to do here is to give taxpayers as reasonable a chance as we can to appeal assessments that in their opinion are unfair and to put all taxpayers on the same basis.[95]

Commentary at the time noted that "[l]awyers and public accountants were somewhat pleased" with this amendment, but that they should have been "even happier" with a further amendment in June 1965 providing deductibility for negotiations in general with tax authorities even where an assessment or formal objection was not involved.[96]

These national amendments were accompanied by an amendment by Ontario to its then separately administered corporation tax also to allow deduction for costs relating to objections or appeals under the relevant Act itself or the federal Income Tax Act.[97] (A corresponding amendment was made to the federal income tax Act in 1981 to extend the deduction for relevant expenses also to those incurred in relation to "an Act of a province that imposes a tax similar to this tax".[98])

The Canadian courts also made the important finding shortly after these amendments that expenses incurred in a tax dispute with US revenue authorities related to preservation of an income-earning right rather than preservation of a capital asset and also that as a foreign tax matter the issue was not governed by the *Smith's Potato Estates* case.[99] Commentary in subsequent years also confirms that the Canadian revenue authority had accepted that business deductions were available for expenses for "[a]dvising and assisting in the preparation and filing of income tax returns where the nature of the taxpayer's business or property is such that

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[94] *Income Tax Amendment Act 1964*, 13 Eliz. II c 13, s 3(5) introducing new s 11(1)(w) to the *Income Tax Act* 1952 (Can.). A deduction for certain legal expenses had also been introduced in 1961.
[95] Canada, Parliamentary Debates, House of Commons (14 May 1964) 3286.
[96] *Income Tax Act and Federal-Provincial Fiscal Arrangements Act Amendment Act 1965*, 14 Eliz. II c 18, s 2 adding new s 11(1)(aa) providing deductibility for expenses in making relevant representations to domestic or foreign national or subnational governments or specified public bodies. See Edwin C Harris, "Liberalized Expense Deductibility – Whither the Capital Outlay?" (1966) 12(2) *McGill Law Journal* 145, 153.
[97] *Corporations Tax Amendment Act 1965* (Ont.) s 5(2).
[98] *Income Tax Amendment Act 1981*, 29-30 Eliz. II c 48, s 29(5). The relevant deduction provision of the Income Tax Act at this time was s 60(o).
[99] *Premium Iron Ores Ltd v Minister of National Revenue*, [1966] SCR 685. See n 30 above.

it is a normal part of operations of that kind to obtain legal and accounting services".[100] Distinctively, however, individual tax return preparation costs continue to be non-deductible in Canada along UK lines even though tax dispute-related expenses qualify under the statutory deduction.

It is also relevant to note that deductibility in Canada is restricted to relevant amounts "to the extent that the outlay or expense was reasonable in the circumstances",[101] a rule dating back to enactment of a provision in 1933 allowing the relevant Minister to "disallow as an expense the whole or any portion of any salary, bonus, commission or director's fee which in his opinion is in excess of what is reasonable for the services performed".[102]

In New Zealand's case, it can also be noted that a wide-ranging deduction for tax-related expenses was added to the income tax law in New Zealand by that country's Marshall National government in September 1972,[103] just before its fall to the Labour Opposition in the November general election.

Even though New Zealand has had a long-established system of substantial deduction of tax at the source for wage earners so that a large proportion of such taxpayers do not need to file a tax return,[104] the 1972 provision combined allowance for costs for all taxpayers in the "calculation or determination of the assessable income" with further allowance of expenses relating to objections and appeals. The current provision in substantially this form also now allows similar expenditure relating to GST.[105]

The provision has received some judicial limitation, in the form of decisions finding certain travel expenses to discuss tax matters not deductible.[106] Thus far, there appear to have been no moves to wind back these more moderate concessions in the field in Canada and New Zealand.

D Narrow approaches allowing deductions for some tax-related expenses only for business: United Kingdom, Hong Kong SAR and South Africa

[100] Eva M Krasa, "The Income Tax Treatment of Legal Expenses" (1986) 34(4) *Canadian Tax Journal* 757, 782, referring to Interpretation Bulletin IT-99R3, para 2.
[101] *Income Tax Act*, RSC 1985 c 1, s 67,
[102] David Duff, Benjamin Alarie, Kim Brooks, Geoffrey Loomer and Lisa Philipps, *Canadian Income Tax Law* (LexisNexis, 4th ed, 2012) 1274.
[103] *Land and Income Tax Amendment Act (No 2) 1972* (NZ) (enacted on 14 September 1972) s 23, introducing into the *Land and Income Tax Act 1954* new s 129CG.
[104] Australian Treasury, *Report on Aspects of Income Tax Self Assessment*, n 49, App 4 "International comparisons". The withholding at source is described as "cumulative" in seeking to provide for total deductions of tax to match the taxpayer's income tax liability for the year: OECD, *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies* (OECD, 2015) 297.
[105] *Income Tax Act 2007* (NZ) s DB 3.
[106] See, for example, *Yurjevich v Commissioner of Inland Revenue* (1991) 13 NZTC 8185 (High Court, Savage J). By contrast, the Australian Taxation Office has recently ruled travel at least to the location of a recognised tax adviser to be deductible as an expense in managing tax affairs: TD 2017/8.

The UK has not made any statutory provision for deduction of tax-related expenses to broaden the position applying under the *Smith's Potato Estates* decision.[107] However, the UK revenue authorities continue to allow the cost of preparation of business tax accounts to be deducted.[108]

The UK's partial shift to a self-assessment system for those taxpayers required to file returns (including corporations) in the 1990s brought calls for statutory relief for tax-related expenses to accompany the change. Commentators in one case noted the importance of a rule allowing deduction "for the costs of tax advice, costs of preparing their tax returns and attending to their tax affairs", but also emphasised that it would be unfair for taxpayers not using an agent not to be allowed a similar deduction as compensation for the burden and also to prevent encouragement of the use of agents.[109]

Many individual UK taxpayers otherwise continue not to need to file a tax return, however, and in 2013-14 the country's cumulative withholding system was enhanced by a move to "real-time information (RTI)".[110]

It appears that the position under the *Smith's Potato Estates* ruling also continues to apply in the Hong Kong Special Administrative Region of China. Some commentary in 1975 pointed out that the allowable deductions provision in the profits tax was broader than the UK provision and closer to the Australian legislation, so that it was "arguable that [the *Smith's*] decision is not applicable to Hong Kong" and was "readily distinguishable".[111]

However, this conclusion would also need to be considered in light of the subsequent Australian case that the difference in the wording of the UK and Australian deduction provisions did not allow the *Smith's* case to be distinguished in Australia.[112] There is some evidence in any event however that the Inland Revenue Department does allow business deduction of professional tax filing costs.[113]

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[107] The restrictiveness of the UK position as against the US approach did receive academic criticism in 1963: Benjamin Nadel, "Legal and Accounting Expenses to Contest Tax Liabilities" [1963] 6 *British Tax Review* 423. See now *Income Tax (Trading and Other Income) Act 2005* (UK) s 34(1) and *Corporation Tax Act 2009* s 54(1): "In calculating the profits of a trade, no deduction is allowed for – (a) expenses not incurred wholly and exclusively for the purposes of the trade…"; *Income Tax (Earnings and Pensions) Act 2003* s 336(1): "The general rule is that a deduction from earnings is allowed for an amount if - … (b) the amount is incurred wholly, exclusively and necessarily in the performance of the duties of the employment".

[108] Glen Loutzenhiser, *Tiley's Revenue Law* (Bloomsbury, 8th ed, 2016) 462, noting Statement of Practice SP 16/91 amended for self-assessment by RI 192.

[109] Cedric Sandford and Ian Wallschutzky, "Self-Assessment of Income Tax: Lessons from Australia" [1994] 3 *British Tax Review* 213, 217. The compliance costs in general of self-assessment also received criticism at the time: Sue Green, Self Assessment: A New Era for United Kingdom Taxpayers, But What About the Costs?" [1996] 2 *British Tax Review* 107, 111-112; caution was also expressed however whether the full extent of higher compliance costs in Australia would translate to the UK system under the change: Michael Walpole, "Taxation Compliance Costs: Some Lessons from 'Down Under'" [1999] 4 *British Tax Review* 244.

[110] OECD, n 104, 298-299, also reporting suggestions of a marginal impact on employers of this system.

[111] P G Willoughby, "The Deduction of Expenses for Profits Tax and Salaries Tax" (1975) 5(1) *Hong Kong Law Journal* 39, 48-49.

[112] *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601 at 628. See n 33 above.

[113] See, for example, the Hong Kong Institute of Chartered Secretaries' 2012 model answer to an international scheme examination on Hong Kong taxation, pp 3 and 6, noting annual business audit and tax filing fees as deductible: https://www.hkics.org.hk/hkicsFckEditor/file/Exam%20Diet%20(Dec%202012)/Suggested%20ans/HKTX%20suggested%20answer%20(Dec%202012).pdf (accessed on 22 June 2018).

South Africa's formal move to depart from the UK legal system took place shortly after the *Smith's Potato Estates* case with the enactment of the *Privy Council Appeals Act, 1950* (SA). While decisions relating to the UK by the House of Lords may not have been strictly binding in South Africa even before that Act, the Supreme Court of Appeal (at that time the Appellate Division) in any event found in 1954 that decisions of the Privy Council predating the 1950 Act were "no longer absolutely binding".[114] In general, however, significant South African court decisions in 1936 and 1946 on the test for deductibility of business expenditure adopting a strict purpose approach along the lines of UK decisions to that point remain influential in current South African tax law.[115]

Nevertheless, it appears that at least some tax preparation expenses incurred by businesses are now accepted in South Africa as qualifying for deduction as "expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature" and not excluded as moneys "not laid out or expended for the purposes of trade".[116] The South African Revenue Service has also ruled that specified expenses "for the completion of income tax returns" incurred by individuals can be deducted but only against remuneration of a business nature and not against income in the form of salary or wages.[117]

For individual taxpayers, the South African tax system involves a cumulative withholding at source system along UK lines.[118] However, a recent preliminary study has found that individual taxpayer compliance costs in South Africa in terms of time and fees incurred are nevertheless at the high end of the range for the numerous countries which have been studied in this way.[119]

IV. CONCLUSION

The principal objective of introducing the cost of managing tax affairs deduction was to foster improved tax compliance through increased use of registered tax agents. While Australia's individual taxpayers have the second highest rate of tax agent use in the OECD, it is important to not conflate this result with improved tax compliance outcomes.

This article fills a gap in the literature which has to date not presented a detailed longitudinal analysis of the evolution of this particular deduction. It traces the history of Australian legislative provisions and relevant case law on the development of the law on deductibility, with a focus on tax-related expenses. This is followed by an examination of the recommendations in reviews such as the Ligertwood Report and the Henry Review. As noted

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[114] H R Hahlo and Ellison Kahn, *The Union of South Africa: The Development of its Laws and Constitution* (Stevens & Sons and Juta & Co, 1960) 31.

[115] D J M Clegg, "Compensation and Damages: A Fiscal Pot-Pourri" [2002] *Acta Juridica* 173, citing *Port Elizabeth Electric Tramway Company v Commissioner of Inland Revenue*, 1936 CPD 241 and *Joffe & Co (Pty) Ltd v Commissioner of Inland Revenue*, 1946 AD 157.

[116] *Income Tax Act, 1962* (SA) ss 11(a) and 23(g). See *Appellant v Commissioner for the South African Revenue Service* [2003] ZATC 4 (Special Income Tax Court – Pretoria) noting (at 7) that the Commissioner had initially disputed but subsequently allowed an amount claimed by a business taxpayer in respect of tax services provided by an auditor.

[117] South African Revenue Service, "Deduction of fees paid to accountants, bookkeepers and tax consultants for the completion of income tax returns", Practice Note No 37 of 1995, http://www.sars.gov.za/Legal/Interpretation-Rulings/Pages/Find-a-Practice-Note.aspx.

[118] OECD, n 104, 303, Table 9.5.

[119] Karen Stark and Sharon Smulders, "Compliance Costs Matter – The Case of South African Individual Taxpayers", paper presented at the 13th International Conference on Tax Administration, Sydney, 5-6 April 2018.

by the Henry Review, the heavy reliance on tax agents is symptomatic of the complexity in the tax laws, which in turn reaffirms the need for the cost of managing tax affairs deduction. However, academics such as such Breunig and Wurth also note that the use of tax agents may in many cases be more associated with tax minimisation than simply ensuring tax compliance.

Further, this paper presents a unique perspective through a comparative analysis of six other jurisdictions' tax treatment of the cost of managing tax affairs at the individual level; namely, the US, Canada, New Zealand, the UK, Hong Kong SAR and South Africa. By highlighting the range of somewhat pragmatic responses adopted in comparable jurisdictions, this article examines the continuum of legislative approaches ranging from the US's historically broad and liberal approach (that is, until 2017 which saw a significant winding back of deductions in this field, particularly for individual taxpayers), through the intermediate approach of Canada and New Zealand which adopt restrictive general law rules mitigated to some extent by statutory concessions, to the restricted availability of deductions for tax related expenses in jurisdictions such as the UK, where the "wholly, exclusively and necessarily" test applies for individuals not in business. The Australian approach to the deductibility of tax-related expenses appears to share more common ground with the approach taken in the US (prior to the 2017 changes in that country) than it does with any of the other jurisdictions considered in the article.

It is hoped that this discussion will assist in further informing the debate in the Australian context. This is both a timely and pertinent contribution because the debate is inevitably influenced by perceptions used to argue for or against the deduction. On the one hand, this deduction is needed to assist in the protection of taxpayers' rights in being able to pursue legitimate disputes with a much larger revenue authority, is a necessary consequence of complexity in the tax system that taxpayers and their advisers did not create, and is needed for individual taxpayers on horizontal equity grounds given that corporate taxpayers will often have access to such deductions through other deduction provisions (either legitimately or through practical problems with the enforcement of such other provisions). On the other hand, this is a provision which is being heavily utilised by the wealthy, which subsidises their tax minimisation activities and as such cannot be justified on tax policy grounds.

This article makes the observation that Australia has not been alone in struggling to find a coherent and sustainable set of principles to apply to the cost of managing tax affairs deduction. However, it is important to also note that the consequence of this shortcoming is not as far-ranging in jurisdictions such as New Zealand, the UK or the US, where most individual taxpayers do not file a tax return (in the case of the former two countries) or do not file itemised returns (in the case of the latter). This likely points to a broader issue; namely, relative to comparable jurisdictions Australian individual taxpayers are overburdened by the complexity and compliance costs associated with the personal income tax system. As such, future research by the authors will consider whether it might be desirable from a tax policy perspective to target the underlying causes (that is, compliance burdens arising from complexity) that give rise to planning opportunities rather than targeting the symptom (that is, tax planning fees). Further, while there is much political and media commentary in relation to the cost of managing tax affairs deduction, little empirical evidence as to its incidence, cost and benefits currently exists. Accordingly, future research by the authors will also seek to fill this gap in the literature with an evidence-based research approach.