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Dale Boccabella

An ordered approach to the tax rules for problem solving in a first Australian income taxation law course can improve student performance

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Abstract

The core tax legislation that students are expected to understand in a first-time Australian income tax course (and tax legislation that early career tax practitioners are expected to understand) suffers from a number of deficiencies or challenges including overlap in assessable income provisions, overlap in deduction (or cost recognition) provisions, a shortage of express ordering rules and the presence of regime co-ordination rules that are “hidden”. It is little wonder students find income taxation law difficult. However, in spite of deficiencies in the legislation, Australia’s core tax rules do have a conceptual structure and considerable coherence, even if not immediately apparent. An approach to the tax rules that takes account of this structure and coherence is much more likely to lead to better problem solving. The ordered approach in this paper does this. The approach first centres on the conceptual structures in the general provisions, and secondly, if necessary, the “remedial” provisions that address a “failure” of part of the conceptual structure. This article sets out the ordered approach to problem solving. Importantly, the article makes the argument for this approach, partly by reference to the types of errors that can be made where the ordered approach is not adopted.

1. INTRODUCTION

This article makes a contribution to improving the quality of tax problem solving skills of students studying an Australian income tax course for the first time. The approach should also assist tax practitioners in the earlier part of their careers. It does this by suggesting a particular order of application of the tax rules to a transaction. An ordered or structured approach is needed because the core tax legislation students are expected to understand suffers from a number of deficiencies including overlap in assessable income provisions, overlap in deduction or cost recognition provisions, a general lack of express ordering rules and the presence of regime co-ordination rules that are “hidden”.¹

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¹ The deficiencies or challenges of the income tax are briefly explained in P Burgess, G S Cooper, R E Krever, M Stewart and R J Vann, *Cooper, Krever & Vann’s Income Taxation: Commentary and Materials*, 6th ed., Thomson Reuters, Pyrmont, 2009 at paragraphs 2.360-2.470.

In spite of the deficiencies in the legislation, Australia's core tax rules do have a conceptual structure and considerable coherence even if not immediately apparent. It is submitted that student understanding of this structure and coherence and better problem solving is more likely to be achieved if the author's approach to problem solving is adopted.² Briefly stated, the approach centres on the conceptual structures in the general provisions, and from there, the focus turns to "remedial" provisions that address a "failure" of the conceptual structure.

The article argues that students should adopt the suggested ordering in their tax problem solving, as this is the best way of ensuring comprehensiveness and accuracy in the solution. It is also suggested that the suggested ordering better reflects legislative intent (or the correct interpretation of the legislation). Further, through promotion of comprehensiveness that facilitates awareness of relationships between rules, the suggested approach should make a contribution towards the promotion of "deeper learning". The author concedes that following a "disordered approach"³ does not necessarily lead to errors in problem solving as the problem solver may get to the correct outcome in any event.⁴ It is submitted though that the author's ordered approach to the tax rules gives a much higher chance of better problem solving compared to a disordered approach.⁵

Aside from this introduction and the conclusion, the article is in three parts. Part 2 sets out the broad structure or fundamental structure of most of the tax rules studied in a first income tax course. This outline is divided into Receipts, Profits, Gains or Benefits, which activates assessable income or charging provisions (Sub-Part 2.1), and Expenses, Outgoings or Losses, which activates expense conferral provisions (Sub-Part 2.2). Part 3 provides examples of a number of errors that first-time tax students have made in tax problem solving in assignments, tutorial problems, exams, etc, as observed by the author over a considerable period. Some of these "errors" do not necessarily lead to a substantively incorrect answer, although incorrect as a matter of tax law.

² It is possible that first time tax students, on the advice of their tax lecturers, may be using a particular approach. Further, in P Burgess, G S Cooper, R E Krever, M Stewart and R J Vann, *Cooper, Krever & Vann's Income Taxation: Commentary and Materials*, 6th ed., Thomson Reuters, Pyrmont, 2009 at paragraphs 2.380-2.460, the authors have set out a series of questions or issues that should be considered when approaching a tax problem. While this is helpful to the problem solver, this outline does not (and perhaps cannot, given the space constraints): (i) expressly set out an ordered approach to the tax rules (ii) provide reasons as to why an ordered approach to the tax rules maximises the chances of better problem solving and (iii) indicate errors that can be made from using a disordered approach.

³ A "disordered approach" is any approach that is quite different to the one suggested in this article.

⁴ The author recalls his early study of taxation law where making mistakes served as a very good learning opportunity. In a way, having someone else suggest an effective approach to tax problem solving denies the learner the learning opportunities that come from making mistakes.

⁵ The fact the judiciary, when deciding a tax dispute, does not follow the ordered approach set out in this article or any other comprehensive approach is not a reason for students not following the ordered approach. The issue(s) that a tax judge needs to resolve in making their decision is often narrowed down for them by the parties (ATO and taxpayer), mainly because the parties have agreed on the application or otherwise of other relevant provisions.

Part 4 sets out the suggested ordering approach to tax rules in the core areas of study for first time students. Part 4 also explains why the ordered approach is a superior approach to the application of tax rules. At times, this discussion is cross-referenced to the errors in Part 3. The conclusion of the article is that the ordered approach is very likely to lead to better tax problem solving and a deeper understanding of the tax rules.

2. BROAD STRUCTURE AND MAIN FEATURES OF INCOME TAX RULES STUDIED IN FIRST INCOME TAX COURSE⁶

The appendix to this paper gives a brief outline of the topic areas taught in the first income tax course run by the author for students in the Master of Professional Accounting degree at his university. It will be apparent that the central aim of such a course is to assist students determine a taxpayer's liability to the Australian Taxation Office. A major element in calculating taxpayers' liability is their taxable income for an income year.⁷ In turn, taxable income equals assessable income less deductions.⁸ A tax loss will usually be the excess of deductions over assessable income.⁹ It is these two components of taxable income, one generally concerned with receipts and the other expenses, that a first income tax course is primarily concerned with.

2.1 Receipts, Profits, Gains or Benefits

The broad overall aim when dealing with a receipt or profit is to determine whether the legislature intended that the receipt, or part of the receipt, enter the tax base (usually assessable income directly) of the taxpayer. In many situations, this is very likely to require examination of more than one tax rule or more than one provision in the income tax legislation. An appreciation of the character or the role of tax rules will assist in this endeavor.

2.1.1 Ordinary Income Provision (s 6-5)

The ordinary income provision (s 6-5) is the most significant charging provision within the income tax legislation in terms of amounts included in assessable income.¹⁰ It is only a receipt or profit that is "income" that can come within s 6-5. For a particular receipt or profit to be income, it must satisfy certain "positive criteria", and avoid satisfying (fall outside) certain "negative criteria". The criteria are all judge-made law. The positive criteria are referred to here as the five "well recognised" sources or categories of income.¹¹ They are: (1) Proceeds of personal exertion (2)

⁶ It needs to be stressed that where this outline purports to state the tax rules, the outline is limited and is general in nature. That is all that is required for the purpose of this article. If the reader wishes to obtain a deeper understanding of the relevant tax principles, reference must be made to the legislation, cases and commentary in textbooks.

⁷ Subsection 4-10(2) of the *Income Tax Assessment Act* 1997. All references to sections containing a dash (-) are references to the ITAA 1997, unless stated otherwise.

⁸ Subsection 4-15(1).

⁹ I say generally because where a taxpayer has "net exempt income" for an income year, the tax loss is also reduced by net exempt income: s 36-10(3).

¹⁰ It is also likely that the income section (now s 6-5, and before that, s 25(1) of the ITAA 1936) is the second-most litigated provision in the income tax law. The general deduction section (now s 8-1, and before that, s 51(1) of the ITAA 1936) is likely to be the most litigated.

¹¹ It needs to be noted that the income categories are not as neat as suggested above: see discussion of the majority in the High Court in *FCT v Montgomery* 99 ATC 4749 at 4760-4762.

Proceeds of business (3) Return from property (4) Compensation receipts principle (compensation for lost income or lost revenue asset) and (5) Factorial approach to characterisation (i.e. taking account of all the facts, the amount is income).¹² The negative criteria refer to the presence of a fact or circumstance that denies the receipt being income. The presence of just one negative criterion in regard to a positive criterion (category) is enough to prevent an amount being income under that category.¹³

At the risk of over-simplification, and even inaccuracy, the following table attempts to capture the most relevant criteria (principles):

POSITIVE CRITERIA	NEGATIVE CRITERIA
Proceeds of Personal Exertion: The receipt, gain or benefit is a product of the taxpayer's personal exertion	(a) The receipt is received by the taxpayer as a mere gift; or (b) The receipt is received as a mark of esteem; or (c) The receipt is received in recognition of an achievement; or (d) The receipt is received as a sign of respect for the recipient; or (e) The receipt is for giving up a right that is regarded as a capital or structural right; or (f) The benefit, being a non-cash benefit, cannot be converted into money.
Proceeds of Business: The receipt, gain or benefit is a product of the taxpayer's business. This should also cover the so-called isolated business venture (or isolated profit-making venture)	(a) The receipt is received by the taxpayer as a mere gift; or (b) The receipt is received as a mark of esteem; or (c) The receipt is received in recognition of an achievement; or (d) The receipt is received as a sign of respect for the recipient; or (e) The receipt is for giving up a right that is regarded as a capital or structural right "of the business"; or (f) The benefit, being a non-cash benefit, cannot be converted into money.
Return from Property: The receipt, gain or benefit is a return from putting one's property to work	(a) The receipt is a benevolent rental or a contribution to costs; or (b) The receipt is for the sale or realisation of the property, or part of the property; or (c) The receipt is for the grant of a lease over the property (instead of for use of the property); or (d) The benefit, being a non-cash benefit, cannot be converted into money.

¹²The author came across the term "Application of the 'factorial' approach" in R H Woellner, T J Vella, L Burns and S Barkoczy, *1996 Australian Taxation Law*, 6th., CCH, North Ryde, 1996 at paragraph 6.160. The most recent application of the factorial approach to income characterisation seems to be the High Court decision in *FCT v Anstis* 2010 ATC 20-221 at 11,651-11,653 in regard to government youth allowance payments to a university student.

¹³The negative criteria can also be viewed as a failure to satisfy a relevant positive criterion.

Compensation Receipts Principle: The receipt is compensation for lost income or compensation for a lost revenue asset	(a) The compensation is for a lost receipt that would have been capital; or (b) The compensation is for a lost structural asset (capital asset); or (c) The compensation is for damage to, or destruction of a, structural asset; or (d) The compensation is for the loss or destruction of a private asset.
Factorial Approach to Characterisation as Income: On consideration of all the facts surrounding the receipt, it is income	(a) The receipt is received on personal grounds; or (b) Receipt is an instalment of the sale proceeds for an asset.

Aside from the positive criteria and the negative criteria, the income concept is not limited to designated types of receipts or profits, or particular subject matter. And, there is no express ordering rule. That is, there is no guidance advising the problem solver that the ordinary income section must be applied before a specific assessable income section (see below), or the other way around. This issue is addressed under the following topic (Sub-Part 2.1.2).

2.1.2 Specific Assessable Income Provisions, Aside from the Capital Gains Tax Regime and Fringe Benefits Tax Regime

The legislature does not intend s 6-5 to be the only assessable income provision. The legislature wants taxpayers to be taxed on more than just income receipts or income profits for whatever reason.¹⁴ Some examples of provisions (sections) that include amounts in assessable income where s 6-5 may not otherwise apply are: s 15-2 (value of benefits in respect of employment or services rendered), s 15-10 (bounty or subsidy received in relation to carrying on business) and s 15-25 (receipt of payment from former lessee for failing to make repairs to premises). In this sense, the legislature is “correcting” for the deficiency of, or the limitations of, the income concept as developed by the judiciary. As a matter of logic, these assessable income provisions would not be required if the income concept was “broad enough” to capture the receipts dealt with in these provisions.¹⁵

As expected, these specific assessable income provisions usually deal with a particular category of receipts or profits and/or circumstances (e.g. benefits in regard to employment or services rendered: s 15-2, bounty or subsidy in relation to a business: s 15-10). Each specific assessable income section will be correcting for a deficiency (or more than one deficiency) with the income concept; they will not all be correcting for the same deficiency although the “capital” deficiency would feature prominently. That is, the specific assessable income section may be required because the receipt involved is likely to be capital under general principles in s 6-5. Sections 15-10 and 15-65 (grant for leaving sugar industry) appear to be examples of correcting for the capital

¹⁴The equity (or fairness) criterion provides an explanation for the existence of many specific assessable income provisions.

¹⁵These specific assessable income provisions have been given the label “statutory income” by the legislature: ss 6-10 and 6-15.

conclusion. Section 15-2 corrects to overcome the non-convertibility doctrine for non-cash benefits.¹⁶ While s 15-25 may be correcting for the capital conclusion, it may also be correcting for the difficulty of linking the receipt to the former lessee's use of the premises. Subsection 20-35(1) (recoupment of expenses for which certain deductions were obtained) may be correcting for the failure of the judiciary to adopt a general reimbursement principle.¹⁷ Subsection 40-285(1) (recoupment of previous depreciation deductions on sale of depreciating asset) is correcting for the fact that tax depreciation (deductions) was faster than economic depreciation. But, s 40-285(1) also corrects for the capital conclusion in regard to the sale proceeds above original cost of the asset.

It should be noted that not one specific assessable income section studied in a first income tax course expressly requires the receipt or profit to be capital in nature in order for the specific assessable section to apply.

Some specific assessable income sections do not appear to have any real role because the receipts dealt with in those sections are very likely to be income in any event. Section 15-15 (profit from profit-making undertaking), s 15-20 (ordinary royalty), s 15-30 (insurance or indemnity for lost amount that would have been assessable income), s 15-50 (work in progress receipt) and s 70-115 (insurance or indemnity for lost trading stock) are likely to be in this category.¹⁸

At least once where the legislature has corrected for a deficiency in the income concept that correction is not by way of a specific assessable income section. The example is s 21A of the *Income Tax Assessment Act* 1936. This section does not include an amount in assessable income. Rather, the main thing s 21A does is to overcome (displace) the non-convertibility doctrine in regard to non-cash benefits obtained by a business taxpayer.¹⁹ That means that the requirements of s 6-5 (or requirements of any other specific assessable income section) still need to be satisfied in order for the value of the non-cash benefit to be included in assessable income.

There is no express ordering rule. That is, there is no express guidance advising the problem solver that the ordinary income section must be applied before a specific assessable income section, or the other way around. However, many specific assessable income provisions co-ordinate with s 6-5 so that if s 6-5 applies to include the receipt in assessable income, the specific provision will not include the receipt in assessable income (e.g. ss 15-2, 15-10, 15-25). The presence of these express co-

¹⁶A non-cash benefit that cannot be converted into money is not income: *FCT v Cooke and Sherden* 80 ATC 4140 at 4149. In light of the decision in *Smith v FCT* 87 ATC 4883, and in particular, the judgment of Brennan J at 87 ATC 4888, a strong case can be made that employment (s 15-2) is a broader concept than an income-producing activity (s 6-5), and that therefore s 15-2 has a broader operation than s 6-5.

¹⁷A general reimbursement principle could involve a rule such that, where a taxpayer obtains a reimbursement or recoupment of an expense that was deductible under the general deduction section, then the reimbursement would be income: *FCT v Rowe* 97 ATC 4317 at 4319. The existence of such a principle was rejected some 45-years ago in *H R Sinclair Pty Ltd v FCT* (1966) 14 ATD 194 at 195 (per Taylor J) and at 196 (per Owen J). And, more recently, the principle was also rejected in *FCT v Rowe* 97 ATC 4317 at 4321 and at 4329.

¹⁸Given the case law on the predecessor provisions to ss 15-15 (s 25A), 15-30 (s 26(j)) and 70-115 (s 26(j)), it is hard if not impossible to see why the transactions covered by those provisions is not income.

¹⁹Section 21A also seems to provide a valuation rule for all non-cash business benefits (i.e. whether or not the benefit is in fact convertible into money): see introductory words in s 21A(2).

ordination rules makes it hard to suggest that any of the specific assessable income sections exclude s 6-5 from operating. In one sense, these co-ordination rules are ordering rules (i.e. apply s 6-5 first). The co-ordination rules in the specific assessable income provisions can also be seen as anti-double taxation measures.²⁰ It is important to remember that it is a condition of these specific assessable income sections that the receipt not be income. There is also an obscure co-ordination rule on the sale of a depreciating asset so that if the sale proceeds above original cost is income, that part of the sale proceeds are not counted for the purpose of calculating the assessable income inclusion on the sale under the depreciating asset regime.²¹ This can be seen as both an ordering rule and an anti-double taxation rule.

Other specific assessable income sections do not co-ordinate with s 6-5 (e.g. ss 15-3, 15-50 and s 44 of the ITAA 1936). There is no basis for the implication that these specific assessable income sections exclude s 6-5 from applying to the transactions falling under them.²² These sections do not therefore provide an, in effect, ordering rule and nor do they expressly prevent double taxation. In these circumstances, s 6-25 may have to provide the “co-ordination” or ordering rule and also the anti-double taxation rule. Section 6-25 gives priority of operation to the specific assessable income section (over s 6-5), unless a contrary intention appears.²³ It is worth pointing out here that s 6-25 does not apply where a receipt or profit gives rise to income and also a capital gain under the CGT regime. The co-ordination rules in such circumstances are contained within the CGT regime (see Sub-Part 2.1.4 below).

2.1.3 Exempting Provisions, outside of the CGT Regime²⁴

The main point of exempting provisions is that the legislature has decided that certain categories of receipts should not enter taxpayers’ tax base (i.e. not be taxed). Some of these provisions overcome what would otherwise have been an inclusion under the income concept (s 6-5).²⁵ A much smaller number of these provisions overcome what

²⁰Preventing double taxation on the one amount need not be achieved within one of the two sections that would otherwise include the amount in assessable income. Having a general anti-double taxation rule in a stand-alone section should work just as effectively. Indeed, s 6-25 uses this approach: see below.

²¹Subsection 40-300(3).

²²See the analysis in the majority judgment in the High Court case of *FCT v McNeil* 2007 ATC 4223 at 4230-4232 where the majority rejected an exclusive code argument in regard to s 44 of the ITAA 1936. The exclusive code argument would generally have meant that s 6-5 was excluded from applying to receipts that accrued to shareholders in companies because s 44 would have dealt with these exclusively.

²³Section 6-25 probably operates in a similar manner to the rule of statutory interpretation that gives priority of application to a specific provision over a general provision where both could apply: see D C Pearce and R S Geddes, *Statutory Interpretation in Australia*, 7th ed., LexisNexis Butterworths, Sydney, 2011 at paragraphs 4.38-4.40 for a discussion of this principle.

²⁴These types of provisions receive little attention in the Taxation Law course taught by the author.

²⁵Sections 51-1 and 51-5 make pay and allowances received by members of the Naval, Army or Air Force Reserve exempt income. In absence of these sections, these amounts would be included in assessable income under s 6-5. Section 51-57 makes post-judgment interest on a damages award for personal injury exempt income. In the absence of s 51-57, the post-judgment interest would be included in assessable income under s 6-5: *Whitaker v FCT* 98 ATC 4285.

could otherwise have been an inclusion under a specific assessable income section.²⁶ As expected, these exempting provisions deal with particular categories of receipts or profits and/or circumstances. In a sense, each specific exemption provision is correcting for the “overreach” of the assessable income provision that would otherwise apply.

Sometimes, an exempting provision seems to be in the legislation merely to make absolutely certain that a particular receipt is not to be treated as assessable income (i.e. exempting provision probably not required).²⁷

2.1.4 CGT Capital Gains Tax (CGT)

The capital gains tax regime is a significant regime within the income tax in terms of inclusions in assessable income.²⁸ The CGT regime can include an amount in taxpayers’ assessable income if the taxpayer has a “net capital gain”.²⁹ It is important to note that an assessable income inclusion is the only outcome that can arise from the CGT regime for a taxpayer for an income year. The reason for this is that “net capital losses” - the opposite of net capital gains - are quarantined [within the CGT regime] for use only against future net capital gains (i.e. net capital losses are not a deduction).³⁰

It is important to note that the amount that enters a taxpayer’s assessable income under the CGT regime can be the “netting off” of capital gains and capital losses from a number of transactions (CGT events), and not just one transaction. In this regard, the CGT regime is quite different to “other assessable income provisions” mentioned above (Sub-Part 2.1.2). In spite of this, the CGT regime should still be seen as a transaction tax. Indeed, the CGT regime contains numerous rules that designate which capital gains are chargeable gains and which are not, and which capital losses obtain loss recognition and which do not. Some of these rules are designed to prevent double taxation because the receipt or profit on the transaction may already be taxed under the non-CGT regime (e.g. s 6-5).

²⁶Section 59-50 (clean-up and restoration grants for small businesses in regard to the 2009 Victorian bushfires) may be an example of this. These receipts may be included in assessable income under s 15-10, in the absence of s 59-50.

²⁷The exempt income provision dealing with maintenance receipts (s 51-30, along with s 51-50) is probably in this category because such receipts may be regarded as mere gifts given on personal grounds. Section 17-5, which excludes GST on a taxable supply under the GST regime from being included in assessable income, may also provide an example. According to the ATO’s analysis in Class Ruling CR 2002/83, s 51-60 is also likely to be in this category (Prime Minister’s prizes for Australian History, Science, etc). One concern with some of these “exempting provisions”, a minor one, is that if an amount is exempt income, the amount of net exempt income reduces the taxpayer’s tax loss for the income year (s 36-10(3)). The strong implication is that the exempting provision is excluding from assessable income something that is income on ordinary principles. If the receipt is not income in the first place, then it may be that the receipt cannot be exempt income and therefore does not have to be counted to reduce a tax loss. It is arguable that the maintenance payments are in this category; they may not be income in the first place, and yet they are declared to be “exempt from income tax” by s 51-30 along with s 51-50.

²⁸The CGT regime covers Divisions 100-152 of the ITAA 1997. It will be appreciated that the CGT regime is not a separate, stand-alone tax.

²⁹Subsection 102-5(1).

³⁰Section 102-10 and s 102-15.

For a taxpayer to have a capital gain (or a capital loss), a “CGT event” must have occurred.³¹ In a first income tax course, only a small number of CGT events will be studied.³² Most of the CGT events studied involve the sale of, or the cessation of, a pre-existing asset. The formula for a gain is: “capital proceeds” minus “cost base”.³³ The formula for a loss is: “reduced cost base” minus “capital proceeds”.³⁴ Some of the CGT events studied involve transactions that do not involve the sale of a pre-existing asset.³⁵ Given that a particular transaction could fit within more than one CGT event, the CGT regime contains, amongst other things, some ordering rules (i.e. problem-solver must apply or analyse the CGT events in a particular order to the exclusion of some specified CGT events).³⁶ In addition, if a particular transaction is caught by more than one CGT event and the ordering rule does not preclude double counting, there is a rule stating that the most specific CGT event will apply.³⁷

In regard to chargeable gains, the CGT regime can be seen as correcting for deficiencies in the income concept. The CGT regime mainly corrects for the “deficiency” that the income concept does not cover a capital receipt/capital profit.³⁸ This is the overwhelming purpose of the CGT regime. At times though, the CGT regime can also correct for the fact that the income concept does not encompass gains from a hobby, pastime, recreation or a non-business activity or private activity. Gains from the sale of some collectables and some personal-use assets are examples of this.³⁹

It should be noted that the CGT regime is not limited to transactions on capital account. The term “capital proceeds” does not import the requirement that the transaction must be on capital account.⁴⁰ Nor do the terms “capital gain” or “capital loss”. Accordingly, the CGT regime may also apply to transactions on revenue account. However, there is no express ordering rule in regard to a CGT event within the CGT regime and non-CGT assessable income sections (e.g. s 6-5). That is, there is no express guidance advising the problem solver that the ordinary income section or specific assessable income sections (aside from CGT regime) must be applied before applying a CGT rule, or the other way around. However, many rules in the CGT regime state that the CGT regime does not apply (more accurately, the capital gain or

³¹Section 102-20.

³²The author’s course only focuses on CGT events A1, C1, C2, D1 and F1.

³³See for example, ss 104-10(4) and 104-25(3).

³⁴See for example, ss 104-10(4) and 104-25(3).

³⁵CGT event D1 (s 104-35) and CGT event F1 (s 104-110) would fall into this category.

³⁶Subsection 102-25(1) and s 102-25(3).

³⁷Subsection 102-25(1). The rule in s 102-25(1) probably operates in a similar manner to the rule of statutory interpretation that gives priority of application to a specific provision over a general provision where both could apply: see D C Pearce and R S Geddes, *Statutory Interpretation in Australia*, 7th ed., LexisNexis Butterworths, Sydney, 2011 at paragraphs 4.38-4.40 for a discussion of this principle.

³⁸Just because a receipt is “capital” under s 6-5 does not mean it is caught as a capital gain under the CGT regime. To be a capital gain, the receipt or profit must give rise to a capital gain under a CGT event.

³⁹Gains and losses on collectables are only recognised by the CGT regime if the acquisition cost of the collectable was more than \$500: s 118-10(1). Gains are only recognised on personal use assets if the purchase cost was more than \$10,000: s 118-10(3). In a lack of symmetry, losses are never recognised on personal use assets: s 108-20(1).

⁴⁰The term capital proceeds merely describe one element in the calculation of a capital gain or capital loss.

capital loss is disregarded) where a non-CGT rule would apply to the transaction.⁴¹ In one sense, these are ordering rules. These features of the CGT regime can also be seen as anti-double taxation measures. Another important rule within the CGT regime, and one that differs from the gain or loss disregard rules, is directed at preventing double taxation, namely, s 118-20. Where a transaction gives rise to both a non-CGT assessable income amount and a capital gain under the CGT regime, s 118-20 reduces the capital gain by the non-CGT assessable income amount. Again, in one sense, s 118-20 is also an ordering rule.⁴²

2.1.5 Fringe Benefits Tax (FBT)

There is a category of benefits and receipts from employment that are taxed under a separate piece of legislation, namely, the *Fringe Benefits Tax Assessment Act* 1986 (FBTAA). Somewhat unusual under an “income tax”, the taxpayer is the employer (who will usually be the provider of the benefit), and not the employee who receives the benefit.⁴³

Again, the FBT regime can be viewed, in part, as correcting for deficiencies in the income concept (s 6-5). Arguably, the main deficiency would be the non-convertibility doctrine under the income concept.⁴⁴ However, the FBT regime can also be viewed as overcoming the valuation difficulties under the income concept for non-cash benefits, and the valuation difficulties under s 15-2 for non-cash benefits.⁴⁵ The FBT regime contains, for the most part, objective valuation rules that are designed to cater for particular benefits.

The key requirement for the FBT regime to apply to a benefit is that the definition of “fringe benefit” in s 136(1) of the FBTAA is satisfied. There is no express ordering rule. That is, there is no guidance advising the problem solver that the definition of a fringe benefit must be applied before applying the ordinary income rule or s 15-2 to the recipient of the benefit, or the other way around. There is a rule excluding a benefit from an employee’s assessable income where the benefit is a fringe benefit under the FBTAA.⁴⁶ This can be seen as an anti-double taxation rule.

⁴¹For example, see s 118-24 (disposal of Division 40 depreciating asset), and s 118-25 (disposal of trading stock).

⁴²The most obvious situation where s 118-20 would apply to prevent double taxation would be the sale of a revenue asset that is not trading stock.

⁴³Subsection 66(1) of the FBTAA, and ss 5 and 6 of the *Fringe Benefits Tax Act* 1986.

⁴⁴There is no express rule overcoming the non-convertibility doctrine in the FBTAA but, if required, s 148(1)(g) of the FBTAA would probably achieve this (irrelevant whether or not the benefit is in the nature or income).

⁴⁵See for example *Case T76 86 ATC 1076* at 1089 and the cases cited therein. See also Australian Government, *Reform of the Australian Tax System: Draft White Paper*, AGPS, June 1985 at paragraphs 8.1-8.21 for a discussion of the valuation problems and the various solutions available.

⁴⁶Subsection 23L(1) of the ITAA 1936. It is also worth noting that if a benefit is an “exempt benefit” under the FBTAA, the benefit will also be excluded from the recipient’s assessable income: s 23L(1A) of the ITAA 1936. This rule can be seen as preserving the FBT exemption in the hands of the recipient.

2.2 Expenses, Outgoings or Losses

The broad overall aim when dealing with expenses is to determine whether the legislature intended that the expense is to reduce the taxpayers' tax base, either through a deduction or through recognition under the CGT regime.⁴⁷ In most situations, this is very likely to require examination of more than one tax rule or more than one provision in the income tax legislation. An appreciation of the character or function of tax rules will assist the problem solver.

2.2.1 General Deduction Provision (s 8-1)

The general deduction provision (s 8-1) is the most significant expense recognition provision in the income tax legislation in terms of providing for reductions in the tax base.⁴⁸ For a particular expense, outgoing or loss to be deductible under s 8-1, the expense must satisfy one of the "positive criteria", and avoid satisfying (fall outside) the "negative criteria". It is important to note that the positive criteria and negative criteria here is not to be confused with references in the tax literature to the positive limbs and negative limbs under the general deduction section.⁴⁹

Again, at risk of over-simplification, the following table attempts to capture the most common situations or relevant criteria:

POSITIVE CRITERIA	NEGATIVE CRITERIA
(a) If Taxpayer's Activity is one of obtaining proceeds from Personal Exertion: Is the expense, outgoing or loss sufficiently related to the taxpayer's assessable income producing activity; or (b) If Taxpayer's Activity is one of obtaining proceeds from Business: Is the expense, outgoing or loss sufficiently related to the taxpayer's assessable income producing activity; or (c) If Taxpayer's Activity is one of obtaining returns from Property: Is the expense, outgoing or loss sufficiently related to the taxpayer's assessable income producing activity	(a) The expense, outgoing or loss is too remote from the taxpayer's income activity or proposed activity, or it is not a cost of carrying on the activity; or (b) The expense, outgoing or loss is too remote from the taxpayer's income activity or former activity, or it is not a cost arising from the activity; or (c) The expense is only partly incurred for producing assessable income (only part of expense is for taxable purpose); or (d) The expense is private; or (e) The expense is domestic; or (f) The expense is capital; or (g) The expense is related to producing exempt income.

⁴⁷We are not concerned with expenses that provide a tax offset, and in any event, there are very few of these and most likely, none are dealt with in a first income tax course.

⁴⁸The general deduction section is likely to be the most litigated provision in the income tax legislation.

⁴⁹Section 8-1 is usually regarded as containing two positive limbs and three (or four) negative limbs. To obtain a deduction under s 8-1, the expense must satisfy one of the positive limbs and avoid all of the negative limbs.

The positive criterion refers to the idea that the expense must be sufficiently related to the taxpayer's assessable income activity in order that this criterion is satisfied. The negative criteria refer to the presence of a fact or circumstance that denies the expense being deductible under the general deduction section. The presence of just one negative criterion is enough to prevent an amount being deductible under s 8-1. (Most of the listed negative criteria can also be viewed as a failure to satisfy the positive criterion).

Aside from the positive criterion and the negative criteria, the general deduction section is not limited to designated types of expenses, outgoings, losses or particular subject-matter. And, there is no express ordering rule. That is, there is no guidance advising the problem solver that the general deduction section must be applied before a specific deduction section or a CGT asset cost base inclusion section, or the other way around. This issue is addressed under the following topic (Sub-Part 2.2.2).

2.2.2 Deduction Conferral Provisions, Loss Conferral Provisions, Etc, aside from General Deduction Section and Aside from CGT Regime

The legislature does not want s 8-1 to be the only deduction or loss recognition provision. The legislature wants taxpayers to obtain deductions on more than just expenses that satisfy s 8-1, for whatever reason. Some examples of sections that provide deductions or loss recognition where s 8-1 might or would not otherwise apply are: s 25-5 (broadly, tax compliance costs) and s 25-25 (borrowing expenses). These are referred to here as specific deduction sections.

The presence of specific deduction sections means the legislature is “correcting” for the deficiency of, or the limitations of, the general deduction section as set out in the section and as identified by the judiciary. Specific deduction sections would not be required if the general deduction section was “broad enough” to capture the expenses dealt with in these specific deduction sections.⁵⁰ Each specific deduction section will be correcting for a deficiency (or more than one deficiency) with the general deduction section; they will not all be correcting for the same deficiency although the capital deficiency will feature prominently. That is, the specific deduction section is required because the expense involved is likely to be capital under the general deduction section. However, there are times where the relevance or contemporaneity (too remote) deficiencies are corrected through a specific deduction section.⁵¹ There are also times where the correction is made because the expenditure does not satisfy the criterion of being sufficiently relevant to producing assessable income.⁵² And, there are times where the correction is for private expenditure.⁵³ Finally, there is no basis for the implication that any of the specific deduction sections excludes s 8-1 from the applying to the transactions dealt with within them.

⁵⁰These specific deduction conferral provisions have been given the label “specific deductions” by the legislature: s 8-5(3).

⁵¹Section 25-50 (pension or gratuity payment to former employee), s 25-55 (payments to associations), ss 25-60 and 25-65 (contesting elections to a parliament or local government).

⁵²Section 25-5 (tax compliance costs) and s 25-75 (rates and land tax related to producing mutual receipts).

⁵³Section 30-15 (gifts or donations to deductible gift recipients).

As expected, most specific deduction conferral sections usually deal with a particular category of expense, outgoing or loss and/or circumstances (e.g. tax related expenses: s 25-5, borrowing expenses: s 25-25, purchase of depreciating asset: s 40-25). There are also times where the specific deduction provision will only apply to a taxpayer carrying on a particular activity (e.g. s 40-880: business related costs).

The most significant specific deduction conferral sections are the capital allowance, depreciation or amortisation provisions. The main ones are: s 40-25 (depreciating assets), s 40-832 (listed capital project amounts), s 40-880 (business related capital costs) and s 43-10 (capital works). Three features of these provisions are worth pointing out here. First, they only apply if the expenditure relates to the production of assessable income (i.e. taxable purpose). Secondly, they only apply if the expenditure is of a capital nature. The capital requirement in at least some of these capital allowance regimes is not immediately apparent (i.e. hard to see), or at least it is not at the “front of the provisions”.⁵⁴ Thirdly, they all contemplate apportionment of expenditure between the taxable purpose component and the non-taxable purpose component(s).

Some specific deduction conferral provisions do not seem to be required because s 8-1 would seem to confer the necessary deduction in any event. Section 25-10 (repairs), s 25-35 (bad debts) and s 25-40 (loss from profit making plan) may be examples of this. Perhaps having the specific deduction section provides a higher degree of certainty than s 8-1. Some deduction conferral sections or regimes contain internal exceptions, which can give the impression that there is a deduction denial role for the section.⁵⁵

There is no express ordering rule. That is, there is no express guidance advising the problem solver that the general deduction section must be applied before a specific deduction conferral section, or the other way around. While very few specific deduction conferral sections co-ordinate with s 8-1, the specific deduction sections that involve capital allowances, depreciation or amortisation do implicitly co-ordinate with s 8-1 because those regimes can only apply if the expenditure is capital.⁵⁶ Given that the positive criteria within each capital allowance regime is broadly stated so that a given expenditure can fit within more than one regime (i.e. overlap), there are ordering rules and co-ordination rules between regimes to indicate the regime that takes priority. For example, s 43-10 takes priority over s 40-25 where both regimes would otherwise apply to expenditure.⁵⁷ Section 40-832 takes priority over s 40-880

⁵⁴The capital requirement in the depreciating asset regime is contained in s 40-220, which is amongst the cost base inclusion provisions. The capital requirement in the capital works regime is contained in s 43-70(1), which deals with the definition of “construction expenditure”.

⁵⁵Section 25-100 is an example of this, and in particular, s 25-100(3).

⁵⁶If expenditure is capital, s 8-1 cannot apply. If the expenditure is revenue, the capital allowance regimes cannot apply.

⁵⁷Subsection 40-45(2).

where both regimes would otherwise apply to expenditure.⁵⁸ Indeed, subject to CGT cost base or CGT cost recognition,⁵⁹ s 40-880 is usually last in order of application.⁶⁰

Finally, where an expense satisfies more than one deduction section (i.e. double deduction), s 8-10 provides an express rule to prevent this by requiring the deduction to only be deductible under the most appropriate provision.⁶¹

2.2.3 Deduction Denial or Loss Disregard Provisions

This category of provisions (or regimes) denies deductions or loss recognition for certain types of expenditures. The implication is that aside from the deduction denial provision, the designated category of expenditure would be deductible or receive loss recognition. And, that recognition would normally occur through the general deduction section.⁶² Accordingly, deduction denial provisions can be seen as correcting for the broadness (overreach) of the general deduction section, as interpreted by the judiciary. Some examples of deduction denial provisions are: ss 26-52 and 26-53 (bribes to public officials) and s 26-54 (loss or outgoing in pursuance of a serious illegal activity).

At times, the deduction denial provision is only directed at denying part of a deduction otherwise available. A number of these provisions will usually cap the deduction at a “market value”. For example, s 70-20 reduces the deduction to the market value of the trading stock purchased where the taxpayer has paid an inflated price for the trading stock under a non-arm’s length transaction. Section 26-35 does a similar thing in regard to excessive payments made to a relative for their services.

Some provisions that look like deduction denial provisions are really only “deduction deferral provisions”. Subsection 26-10(1) is in this category (no deductions for annual leave, long service leave, etc, until the amount is paid). Sections 82KZM and 82KZMD of the ITAA 1936 are also in this category (deduction for pre-paid expenditure deferred over the period to which the expense relates).⁶³

⁵⁸Subsection 40-880(5)(b).

⁵⁹There are times where the cost base is not relevant in calculating a gain or loss on a CGT event (e.g. CGT event D1, CGT event F1). In these circumstances though, the taxpayer is permitted to take costs of the event into account in calculating the gain or loss.

⁶⁰Subsection 40-880(5).

⁶¹There is no guidance on how to determine the most appropriate provision, but thankfully, in many cases, it will not matter because both sections will give the same amount of deduction and give it at the same time. It is also worth mentioning another anti-double cost counting provision, namely, s 82 of the ITAA 1936. This section prevents an expense being taken into account in working out the profit or loss that is assessable income or deductible respectively on a transaction, where the expense is a deduction in its own right.

⁶²This is not always the case though. There are some deduction denial provisions that are denying deductions that would otherwise arise outside of the general deduction section (e.g. s 26-55).

⁶³The deduction quarantining rules (or tax loss quarantining rules) in ss 26-47(2) and 35-10(2) could also be viewed as deduction deferral rules.

A feature of a number of deduction denial provisions is that many of them only apply to taxpayers that are carrying on a particular income activity (e.g. business, non-business).

There are a small number of examples though where a deduction denial provision seems to have a limited role (if any role) because the expenditure does not appear to come within a deduction conferral section in any event.⁶⁴ The deduction denial provision is often designed to make absolutely certain that a deduction is not available.

2.2.3.1 Some Deduction Denial Regimes are often complicated by Exceptions to the Deduction Denial

The reason for complication is that while these regimes contain a deduction denial rule, they also contain exceptions to the deduction denial rule. This can make it difficult to characterise the rules, or the role of the rules within these regimes. In spite of the presence of exceptions to the deduction denial rule, these regimes must still be seen as deduction denial regimes, rather than as deduction conferral provisions. The rules (regimes) dealing with: (1) entertainment expenditure⁶⁵ and (2) non-compulsory uniforms⁶⁶ can be put into this category.

2.2.4 Cost Base of CGT Asset or other Cost Recognition under CGT Regime

The cost base or reduced cost base of a CGT asset is the main source of recognition for expenditure under the CGT regime.⁶⁷ This aspect of the CGT regime corrects for the fact that expenditure included in the cost base would not otherwise receive recognition under the general deduction section or under a specific deduction section.

The cost base, which is used when calculating a capital gain, contains five elements, and those elements are exhaustive of what can be included.⁶⁸ The first element is the acquisition cost of the asset. For the second element, which deals with incidental costs associated with the purchase and sale of the asset, there is a list of 10 items, and these are exhaustive (i.e. must fit within them otherwise not included).⁶⁹ The items listed in

⁶⁴The most obvious example is s 26-5, which purports to deny deductions for fines and penalties for breaking the law. On the authority of *Mayne Nickless Ltd v FCT* 84 ATC 4458 and *Madad Pty Ltd v FCT* 84 ATC 4739, these types of expenditures are not likely to satisfy the general deduction section. Section 26-40 may provide another example of this, namely, expenses to maintain your spouse or child under 16-years. These expenses, in the great majority of cases, would not satisfy s 8-1. A similar point can be made in regard to s 26-45 (recreational club membership fees) for many taxpayers. A similar point could be made in regard to s 51AH of the ITAA 1936 because the general deduction section does not generally confer a deduction where the taxpayer is not beneficially incurring the expense.

⁶⁵Sections 32-5 to 32-50.

⁶⁶Sections 34-5 to 34-65.

⁶⁷There are a small number of situations where cost recognition is given through a CGT event not involving a cost base (e.g. CGT event D1: s 104-35, CGT event F1: s 104-110).

⁶⁸Section 110-25.

⁶⁹Subsection 110-25(3) and s 110-35. Section 110-35 provides these examples: (1) Remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser (2) Stamp duty or other similar duty (3) Costs of advertising or marketing to find a buyer or seller and (4) Borrowing expenses (such as loan application fees and mortgage discharge fees).

the third element, which deals with costs of owning the asset, while not legally exhaustive, probably cover most expenses that would come within the third element.⁷⁰ One necessary requirement of the fourth and fifth elements is that the expenditure is capital.⁷¹

The reduced cost base, which is used when calculating a capital loss, is essentially the same as the cost base with two qualifications.⁷²

There is no express ordering rule in the CGT regime. That is, there is no rule stating that the problem solver needs to apply the general deduction section or a specific deduction section before applying the cost base inclusion rule, or the other way around. However, there is a rule or collection of rules that state, where expenditure is deductible, that expenditure cannot be included in the cost base of the CGT asset.⁷³ In one sense, this serves as an ordering rule that makes CGT asset cost base inclusion last in terms of priority. However, it is worth noting a prominent exception to this, namely, CGT asset cost base inclusion takes priority over deductions under s 40-880.⁷⁴ The rules prohibiting cost base inclusion where a deduction has been obtained can also be seen as anti-double cost recognition.⁷⁵

3. DEFECTIVE TAX PROBLEM SOLVING FROM A “NON-ORDERED APPROACH”

This part is broken up into “Receipts, Profits, Gains or Benefits” (Sub-Part 3.1) and “Expenses, Outgoings or Losses” (Sub-Part 3.2). The idea is to list some examples involving defective tax problem solving. Part 4 may require a more detailed analysis of the errors in the context of setting out the suggested ordering approach to the tax rules.

3.1 Receipts, Profits, Gains or Benefits

This sub-part groups error types into three broad categories.

⁷⁰Subsection 110-25(4). Subsection 110-25(4) provides these examples: (1) Interest on a loan to purchase the asset (2) Costs of maintaining, repairing or insuring the asset and (3) Rates or land tax, if the asset is land.

⁷¹Subsections 110-25(5) and 110-25(6).

⁷²Third element costs are not counted under the reduced cost base: ss 110-55(1) and 110-55(2). Further, and of lesser importance as time goes on, no elements in the reduced cost base can be indexed for inflation: s 110-55(1).

⁷³Subsections 110-45(1B) and 110-45(2) achieve this for assets acquired (generally) after 12 May 1997. Section 110-40 deals with assets acquired (generally) before 14 May 1997. The rule for exclusion of deductible amounts from the reduced cost base is in s 110-55(4).

⁷⁴Subsection 40-880(5)(f).

⁷⁵The cost base exclusion rules (ss 110-40 and 110-45) are required because s 8-10 (anti-double deduction rule) cannot apply where recognition is not solely under deduction provisions, which is the case with cost base inclusions.

3.1.1 Application of a Provision that contains the Descriptive Receipt Item (Examples 1-5)

This is a very common mistake. In short, the error involves the problem solver being “attracted” to a specific assessable income section because the receipt is listed in the specific assessable income section.

3.1.1.1 Subsidy to Business: Example 1

Where a taxpayer receives a subsidy in relation to carrying on their business,⁷⁶ it may not be correct to state that s 15-10 applies to include the subsidy in assessable income. One requirement of s 15-10 is that the subsidy must not be income.⁷⁷ If it is income, which many subsidies will be because they will be the product of a business,⁷⁸ s 15-10 cannot apply, and s 6-5 will apply.

3.1.1.2 Lease Repair Covenant Receipt: Example 2

A taxpayer, former lessor of commercial property, receives a lease repair covenant payment from a defaulting former lessee. The statement that s 15-25 applies to include the amount in the taxpayer’s assessable income will usually be correct. However, one of the conditions for s 15-25 to apply is that the amount is not income.⁷⁹ If it is income, s 15-25 cannot apply. In most cases, such a receipt will not be income, but in some it may.⁸⁰

3.1.1.3 Royalties and Compensation Receipts: Examples 3, 4 and 5

The observations made above in regard to business subsidies and lease repair covenant receipts are equally relevant to receipts of royalties (s 15-20), compensation for lost assessable income (s 15-30) and compensation for lost trading stock (s 70-115). For these three types of receipts though, it is near certain that they would be income on ordinary concepts and therefore s 6-5 would apply, and not the specific assessable income section mentioned.

3.1.2 Sale of Asset that fits within an Asset Regime (Examples 6 and 7)

This category is similar to the errors in Sub-Part 3.1.1, but it does require a separate treatment because the transaction forms part of a “bigger” regime where one aspect of the regime involves a charging provision.

⁷⁶A “business” is not an entity or an artificial person; it is merely an activity. Accordingly, a business cannot receive a subsidy. A company is an artificial (or legal) person, and a company can operate a business. A company can also “carry on” the activity of holding passive investments.

⁷⁷Subsection 15-10(b).

⁷⁸See discussion in *Reckitt & Colman Pty Ltd v FCT* 74 ATC 4185 at 4186-4191.

⁷⁹Subsection 15-25(d).

⁸⁰The note under s 25-15 contemplates that the receipt of such a payment may be income.

3.1.2.1 Sale Proceeds for Depreciating Asset: Example 6

Upon the sale of a depreciating asset, that is, an asset that has attracted decline in value deductions under s 40-25, students often commence (and complete) their analysis of the sale transaction at s 40-285. This section requires a comparison of the “termination value” and the “adjustable value” to determine if an assessable income gain inclusion is made, or a deductible loss is made. The termination value of the asset does not include an amount included in assessable income under s 6-5.⁸¹

While not common, s 6-5 will apply where the asset is a revenue asset and the asset is sold for an amount above its cost of purchase.⁸² Where this is the case, the answer obtained solely under s 40-285 will not be correct because the amount above original cost will be included in assessable income under s 6-5. The overall answer though in terms of the assessable income inclusion will be correct.⁸³ A related error, sometimes made, is that students’ claim that the sale proceeds for a depreciating asset are on capital account (not income) because the sale transaction is dealt with under Division 40.

3.1.2.2 Sale of CGT Asset: Example 7

Where a taxpayer sells a CGT asset, and therefore the transaction fits within the key CGT event (CGT event A1), an analysis that focuses solely on determination of a gain or loss under the CGT regime may be incorrect. It will be correct where the gain is not income, and not caught by a specific assessable income provision outside the CGT regime. However, without actually undertaking the income-capital analysis under s 6-5, the problem solver has not shown that the gain is not income. And, if the gain is income, the CGT answer will not be correct because the effect of s 118-20 has not been taken into account. Section 118-20 reduces the capital gain by the income amount so as to prevent double taxation, once under s 6-5 and again under the CGT regime. The incorrect answer has considerable significance for the taxpayer and the ATO because many capital gains made by individuals are discounted by 50% (i.e. only taxed on half the gain).⁸⁴ Income gains (s 6-5) cannot be discounted.

Another common problem is to deal with the sale of a depreciating asset (asset subject to s 40-25 decline in value deductions), which will also be a CGT asset, under the CGT regime. This leads to an incorrect answer as there is a provision dealing with such sales under Division 40,⁸⁵ and the gain or loss from such sales are excluded from

⁸¹ Subsection 40-300(3).

⁸² See *Memorex Pty Ltd v FCT* 87 ATC 5034 and *FCT v GKN Kwikform Services Pty Ltd* 91 ATC 4336 for examples of revenue assets that also attracted depreciation deductions (i.e. depreciating assets) being realised for amounts above original cost.

⁸³ For example, the sale of a depreciating asset which is a revenue asset of the taxpayer and which had: (a) sale price of \$10,000 (b) purchase cost of \$8,000 and (c) adjustable value (tax written down value) at the date of sale of \$5,000, would give rise to an assessable income inclusion of \$5,000. Of this \$5,000, \$2,000 (\$10,000 - \$8,000) will be included under s 6-5 and \$3,000 (\$8,000 - \$5,000) will be included under s 40-285(1). If the asset were not a revenue asset, s 40-285(1) would include the whole \$5,000 (\$10,000 - \$5,000) in assessable income.

⁸⁴ Step 3 of Method Statement in s 102-5(1) and s 115-5.

⁸⁵ Section 40-285. It should also be noted that the problem solver should have started at s 6-5.

the CGT regime.⁸⁶ Like that immediately above, the incorrect answer has considerable significance for the taxpayer and the ATO because many capital gains made by individuals are discounted by 50% (i.e. only taxed on half the gain).⁸⁷ Non-CGT assessable income amounts (s 40-285) cannot be discounted. Of further significance, capital losses under the CGT regime can only be used against capital gains (under CGT regime). A deduction under s 40-285 can be used against all assessable income amounts.

3.1.3 Focus Solely on Exemption Component within a Taxing Regime: Example 8

The taxpayer purchased a home as a residence in 1984. She lived in the home until 2000, and then rented it out for the next 11-years before selling it in 2011. She made a profit on the sale. An answer to the tax question raised by the sale transaction that focused solely on the gain disregard regime for main residences in the CGT regime⁸⁸ is likely to lead to an incorrect answer.

Under the main residence provisions, the taxpayer will only be eligible for a partial exemption on the gain made because the dwelling was not her main residence at all times during her ownership period.⁸⁹ This could lure the problem solver into thinking that part of the gain is a [chargeable] capital gain because only part of the gain is exempt under the main residence regime. This would be incorrect because the gain does not satisfy one key positive criterion of the charging provisions in the first place, namely, that the asset is acquired after 19 September 1985.⁹⁰

3.1.4 Focus narrowly on one Deficiency in Ordinary Income Concept: Example 9

A taxpayer who is not an employee, but who is rendering services (e.g. independent contractor) but not in the form of a business, receives a non-cash benefit that cannot be converted into money. The problem solver correctly states that the benefit cannot be income. However, often the problem solver goes on to state that s 21A of the ITAA 1936 overcomes the non-convertibility doctrine under s 6-5 and therefore the arm's length value of the benefit is included in assessable income. The answer is technically incorrect because s 21A only deals with a business taxpayer. The correct answer would have been that s 15-2 applies.

3.2 Expenses, Outgoings or Losses

This sub-part groups error types into two broad categories and a miscellaneous category.

⁸⁶Section 118-24.

⁸⁷Step 3 of Method Statement in s 102-5(1) and s 115-5.

⁸⁸Subdivision 118-B.

⁸⁹Subsection 118-185.

⁹⁰Subsection 104-10(5)(a). I will ignore the controversy created by s 118-192, namely, the possibility that the section "transforms" or "rolls forward" the acquisition date of a pre-CGT residence to a post-CGT acquisition date.

3.2.1 Application of a Provision that contains the Descriptive Expenditure Item (Examples 10-13)

Similar to the problem under receipts or profits above, this is a very common mistake. In short, the error involves the problem solver being “attracted” to a specific deduction conferral section or an element of the cost base of a CGT asset, because the expenditure is listed in the specific deduction conferral section or the element of the cost base.

3.2.1.1 Theft of Money by Employee: Example 10

An answer that suggests that s 25-45 will apply to confer a deduction is likely to be correct in most cases. However, there is nothing preventing this transaction from being a deduction under s 8-1.⁹¹ Indeed, and even though debatable, it is unlikely that the criteria for deductibility under s 8-1 in regard to a theft of money will be as restrictive as the criteria set out in s 25-45 (e.g. theft must be by employee or agent, money must have been included in assessable income). In addition, if both s 8-1 and 25-45 apply, the problem solver has not resolved the double deduction issue by reference to s 8-10.

3.2.1.2 Interest on Loan, Rates and Land Tax and Repairs to Property that is a CGT Asset: Example 11

Where a taxpayer incurs these expenditures in regard to an income producing rental property, an analysis that states that the expenditures are included in the third element of the cost base of the property for CGT purposes is completely incorrect. These items are expressly mentioned in the third element.⁹² However, the problem-solver has failed to consider deduction sections that may apply (will apply) to the expenditure, which in turn means the problem solver has failed to consider the cost base exclusion rule for deductible expenditure. Even though it is not a material error, the problem solver has also failed to deal with a specific deduction conferral section that expressly deals with repairs.⁹³

3.2.1.3 Stamp Duty on Purchase of Income-Producing CGT Asset, Legal Fees for Solicitor, Borrowing Expenses: Example 12

These expenses are associated with the purchase of an asset, a CGT asset. The analysis here is often along the lines that these expenses are included in the second element of the cost base of the asset because they are expressly listed in s 110-35. At times, the comment is also made that they are capital expenditure and that is the reason why they are included in the cost base.

There are many errors here. It is true that all three expenses are expressly covered by the second element of the cost base. However, just like immediately above, the problem-solver has failed to consider deduction sections that may apply to the expenditure, which in turn means the problem solver may also have failed to consider

⁹¹The reasoning and decision in *Charles Moore & Co (WA) Pty Ltd v FCT* (1956) 11 ATD 147 would provide a strong authority.

⁹²Subsection 110-25(4).

⁹³Section 25-10.

the cost base exclusion rule for deductible expenditure. This will be the case at least in regard to the borrowing expenses. They are deductible under s 25-25. And there is no analysis as to why s 8-1 does not apply to any of the expenses, which may have meant that the borrowing expenses also satisfied s 8-1. Further, there was no analysis as to why each expense was capital. And, in any event, there is no requirement that expenditure must be of a capital nature for it to be included in the second element of the cost base.⁹⁴

3.2.1.4 Travel Expenses from Home to a Workplace: Example 13

Where a taxpayer, who is “on call” like the taxpayer in *FCT v Collings*⁹⁵ (i.e. work begins at the time the taxpayer receives a phone call at home from their employer), travels “to” work, an analysis that states that the taxpayer is denied a deduction for the travel costs because of s 25-100(3) is incorrect. Subsection 25-100(3) states that travel between 2 places is not “travel between workplaces” if one of the places you are travelling between is a place at which you reside (home).

The error here is that s 25-100(3) is only relevant to s 25-100; indeed, the only thing s 25-100(3) does is provide an exception to the “travel between workplaces” concept. The taxpayer in *FCT v Collings* is obtaining her deduction under s 8-1, not s 25-100. Section 25-100 remains irrelevant to the operation of s 8-1.⁹⁶ The other error that this reasoning reveals is that a specific deduction conferral section is being viewed as a deduction denial section.

3.2.2 Analysis Commences at a Deduction Denial Regime (Example 14)

This is also a common mistake. Similar to the above category of errors, this error is largely based on the idea that the problem solver is “attracted” to the deduction denial regime because the expenditure fits the description in that regime. Only one example is provided.⁹⁷

3.2.2.1 Entertainment Expenditure: Example 14

The suggestion is often made that s 32-45 provides a taxpayer with a deduction for entertainment expenses (e.g. providing *entertainment to promote or advertise to the public a *business or its goods). This analysis is incorrect. Section 32-45 does not confer a deduction; it is not a specific deduction conferral section. Section 32-45, in combination with s 32-25, merely “restores” a deduction that has been denied by operation of s 32-5. Section 32-5 contains the deduction denial rule. The relevant part of s 32-5 reads: “To the extent that you incur a loss or outgoing in respect of providing

⁹⁴One would expect however that most of the expenses that come within the second element of the cost base would, most of the time, be of a capital nature because of the requirement in s 110-35(1) that the expenses be incurred to acquire a CGT asset or they were incurred in relation to a CGT event (usually a sale).

⁹⁵*FCT v Collings* 76 ATC 4254.

⁹⁶Another mistake is to analyse travel expense situations under s 25-100, presumably because s 25-100 uses the word “travel”. The incorrect analysis is limited to s 25-100, even when the taxpayer only has one income activity.

⁹⁷Another example that could be provided involves the non-compulsory uniform rules in Division 34.

*entertainment, you cannot deduct it under section 8-1.” The words: “Section 32-5 does not stop you deducting...” in s 32-25 is the authority for this. Restoring a deduction is the only role of s 32-45 (in combination with s 32-25). Therefore, the conferral of a deduction for entertainment expenditure must come from the general deduction section (s 8-1) there being no other section conferring a deduction for such expenditure. This is also the clear implication from s 32-5.

One question is, does this incorrect reasoning lead to an incorrect answer on the deductibility question? The answer is probably not, but this would be through “good luck”, rather than sound tax problem solving. The key point is that when one examines the three circumstances in s 32-45, all of those situations described would seem to satisfy the general deduction section.⁹⁸ Let me repeat though, our problem solver has not applied s 8-1, the only possible deduction conferral section, to the relevant expenditure. The problem solver will not end up at the correct conclusion where the described circumstances do not satisfy s 8-1.

The point made about s 32-45 can equally be made about ss 32-30 to 32-40 and s 32-50, other provisions within the entertainment deduction denial regime.

3.2.3 Miscellaneous Errors (Examples 15-17)

3.2.3.1 Capital Requirement in Capital Allowances Regimes or CGT Cost Base Elements Forgotten: Example 15

Often an answer is given that a capital allowance regime applies to provide a deduction for expenditure. Similarly, CGT asset cost base inclusion via the fourth and fifth element is also provided as a solution for an expenditure item. Rarely do these sorts of answers address the requirement in the capital allowance regimes and the fourth and fifth elements of cost base that the expenditure must also be of a capital nature to come within those regimes/provisions. Also, in many cases the revenue-capital character of the expenditure was not even addressed under s 8-1.

3.2.3.2 Expenditure Items are Capital because they fit the Description in a Capital Allowance Regime or Cost Base Element: Example 16

This is a common error in tax reasoning, yet the error does not necessarily lead to an error in the solution. For example, it is often said that because an item of expenditure fits within an element of the cost base, the expenditure must be capital under s 8-1 or s 25-10 (repair section). Clearly, this reasoning is incorrect. There is nothing in the legislation (or logic) that suggests this is a valid approach to the tax rules.

In many cases, expenditure items that come within the cost base will be capital expenditure, but the obvious point is that there will be times when they are not. This is where solutions will be incorrect.

⁹⁸There is an outside chance that an initial one-off promotion and advertising expenditure might give rise to a capital outgoing (and therefore not satisfying s 8-1) on the basis of the reasoning in *Associated Newspapers Ltd v FCT*; *Sun Newspapers Ltd v FCT* (1938) 5 ATD 87 at 94.

3.2.3.3 Capital Allowance Regimes not considered where Capital Repair Expenditure involved: Example 17

The mistake often made is that no thought is given to including expenditure in the “cost base” recognition rule under Division 40⁹⁹ or Division 43¹⁰⁰ once the expenditure has been found to be capital under s 25-10. Instead, the usual response is to include the capital expenditure in the fourth element of the cost base under the CGT regime. This has also been the response where the only asset involved is a depreciating asset within Division 40 (s 40-30). It will be appreciated that, effectively, depreciating assets used 100% for income production are outside the CGT regime.¹⁰¹

4. NATURE OF TAX PROBLEM AND ORDER OF APPROACH TO THE TAX RULES FOR PROBLEM SOLVING

4.1 Key Questions for Taxpayers (and Students) and the Nature of the “Problem”

The income tax is a transaction tax in the sense that the taxable event that tax rules apply to is usually the transaction entered into by the taxpayer. In a first income tax course, the key issues for students are: (1) When does a receipt or profit enter taxpayers’ assessable income and (2) When do taxpayers obtain a deduction or recognition (e.g. inclusion in cost base of a CGT asset) from the tax rules for costs or expenses incurred or paid. Obviously, a first tax course also deals with some other matters. For example, when is a benefit received by an employee taxed under the fringe benefits tax regime, rather than in the hands of the employee; is a taxpayer entitled to a tax offset; what is the amount of tax payable. Some of these examples however also involve the assessable income inclusion question (e.g. benefit received by an employee). Overall though, the inclusion of amounts in assessable income, and the inclusion of amounts in deductions or other cost recognition provisions from transactions entered into by the taxpayer is the central focus.¹⁰²

As will be apparent from Part 2, the difficulty facing the problem solver is that there is not just one assessable income section in the income taxation law, and there is not just one deduction section. Further, there is a mixture of general sections, that are not limited to particular receipts or expenses, and specific sections that deal with particular receipts and expenses. This means that, in the case of a receipt or profit, the transaction may have to be analysed under more than one assessable income section. At times there is specific and express co-ordination between sections, but at other times the co-ordination is not obvious. The approach to co-ordination between the non-CGT assessable income provisions and the CGT regime is not always the same. Similar observations can be made in regard to outgoings, expenses or losses. Indeed, the co-ordination problems are even more difficult here. For example, there are times

⁹⁹ Section 40-190 (second element of cost base of depreciating asset).

¹⁰⁰ Sections 43-10 and 43-70 (construction expenditure for capital works).

¹⁰¹ Section 118-24.

¹⁰² This is generally the case even where the determination of the “taxable income” of a partnership, trust estate or a company is involved.

where two sections operate in tandem to facilitate the conferral of a deduction to the taxpayer.¹⁰³ This is very uncommon for an assessable income inclusion.¹⁰⁴

The challenge is to adopt an approach to the tax rules that takes account of the multiple sections that can apply to a transaction, the nature of the various sections that can apply to a transaction and the differing approaches to co-ordination between sections and regimes. This is the only way to maximise the chances of more correct answers on a consistent basis; correct answers being those that equate with the legislative intent for the relevant taxpayer's transaction. The suggested approach is directed at this. At the same time, it is hoped that the approach adopted facilitates deeper understanding of the tax rules.

4.2 Order of Approach to Tax Rules when dealing with Receipts, Profits, Gains or Benefits

The presence of the fringe benefits tax regime, where a central criterion is an employment relationship, requires the approach in regard to receipts or benefits to be broken into two.

4.2.1 No Employment Relationship

4.2.1.1 Ordered Approach

The following steps are the suggested order of application of the tax rules where there is no employment relationship between the payer and payee (taxpayer). Note also the ordered approach within each regime/section within each step:

1. The ordinary income section (s 6-5);
2. Specific assessable income sections (e.g. ss 15-2, 15-10 and 40-285), aside from the capital gains tax regime;
3. Exempting provisions (outside the CGT regime); and
4. The capital gains tax regime.

Importantly, where the problem-solving forum for the tax course permits (e.g. tutorial; seminar; to a lesser extent, written assignments), it is suggested that all of the above steps are engaged in, even where s 6-5 applies (Step 1) to include an amount in the taxpayer's assessable income.¹⁰⁵

Importantly, in regard to Step 1, the analysis ought to be comprehensive in the sense that the key positive criteria and the key negative criteria of the income concept are considered in turn. The reason is that the specific assessable income sections and the CGT regime correct for deficiencies (not all) in the income concept so that many of

¹⁰³Where expenditure on capital works on a CGT asset is involved, part of the expenditure may be deductible and the other part may be included in the cost base of the CGT asset.

¹⁰⁴The combination of s 6-5 and s 21A of the ITAA 1936 in regard to non-cash business benefits may provide one example involving assessable income inclusions.

¹⁰⁵Certainly, in an exam or test situation, time may not permit the full analysis that would otherwise be possible in a tutorial or seminar discussion. In these circumstances, lecturers may be content to assume that by coming to the correct answer, you have undertaken, at least mentally, the relevant analysis.

the central concepts/criteria (both positive and negative) are adopted or corrected for in specific assessable income sections and the CGT regime. The main deficiency (or deficiencies) not corrected for are the mere gift and personal recognition situations (i.e. not taxed). In short, it is suggested that it is more likely that better quality problem solving will take place under the specific assessable income sections where the problem solver brings the “full picture” from s 6-5 to the specific assessable income section (Step 2), and for that matter, Steps 3 and 4.¹⁰⁶ The idea is that where the problem solver has formed a view about the taxpayer’s activity or transaction under general principles (s 6-5), it is harder for that problem solver to erase or contradict that view when undertaking the required analysis under a specific assessable income section. One needs to bear in mind that specific assessable income sections can provide new “distractions” for the problem solver.

For example, take a taxpayer that owns a rental property and who is deriving passive property income (not income from a business). The taxpayer receives a subsidy to assist with extending a building on the property. It is likely that the subsidy will be capital under s 6-5. If the problem solver also observes or notes when undertaking the s 6-5 analysis that the taxpayer’s rental property activity is not a business, the problem solver is likely to bring that non-business conclusion into the s 15-10 analysis and therefore, in all probability, avoid the error of concluding that s 15-10 applies to the subsidy. The problem solver who merely concludes under s 6-5 that the subsidy is capital will be starting the s 15-10 analysis from scratch. This will not necessarily lead to an error because the problem solver may simply undertake a comprehensive analysis of the passive property income-business distinction under s 15-10.

One the other hand, there is a danger with the full picture approach. The danger is that the problem solver may make the mistake of “transporting” criteria that is only relevant to s 6-5 into the criteria for a specific assessable income section. A very common mistake is to transport the non-convertibility doctrine under s 6-5 into a criterion under s 15-2. The problem solver needs to guard against this type of error.

A similar approach to that taken in Step 1 ought to be also taken in Step 2. Many specific assessable income sections have a positive requirement(s) and a negative requirement(s). Like the approach to the positive and negative criteria within the ordinary income section, it is suggested that the positive and negative requirements of specific assessable income sections are analysed in turn.

Very few exempting provisions (outside the CGT regime) are considered in a first income tax course (Step 3).

A similar approach to that taken in Step 2, albeit modified, can be taken in regard to Step 4. That is, the focus should first be on CGT events, and the rules therein, that give rise to a gain or loss. CGT events can also be regarded as the positive criteria even though the sections that contain each CGT event also contain the pre-CGT asset

¹⁰⁶It will be appreciated that having the “full picture” in regard to the taxpayer’s activity also provides assistance in regard to cost recognition questions: see below.

acquisition exclusion.¹⁰⁷ And within the “positive criteria”, the correct ordering approach to CGT events within the CGT regime should be adopted (i.e. CGT events dealing with pre-existing assets first, then CGT event D1 and then CGT event H2). Only after the analysis of the positive requirements of the CGT regime (CGT events) is consideration of gain disregard or loss disregard rules (exemptions or exclusions) required. This could also be regarded as negative criteria.

4.2.1.2 Justification for Ordered Approach

The central justification for the suggested approach is that its application is more likely to lead to a correct answer to a tax problem, or is less likely to lead to errors. The reason is that the approach, where properly followed, should permit a comprehensive analysis of the problem whereby all provisions or regimes or rules within regimes that can govern the tax outcome of the transaction are considered. Indeed, the ordered approach is likely to be the only way in which co-ordination between the rules can be achieved; properly applying the interaction between regimes to a transaction will in many cases be necessary to achieving a correct answer.

This does not guarantee a correct answer to a tax problem because the problem solver still has to identify the relevant rules, determine the scope of those rules and deal with characterisation issues within those rules. The ordered approach suggested here does not assist, and is not intended to assist, in this regard. Further, the suggested approach will not necessarily be superior to other approaches for all problem solvers, all of the time, because the problem solver using another approach may end up with the required coverage of relevant provisions in any event. For example, a problem solver might commence at the CGT provisions first and conclude that the profit on the sale of an asset is a capital gain. Then, he or she “may” work through s 118-20 (anti-double taxation provision), which may have the effect of pointing the problem solver back to s 6-5 to see if the gain is income. This problem solver may end up at the correct answer, but it is not clear what system the problem solver is employing so that achieving comprehensiveness on a consistent basis is less likely. The ordered approach in this article is far more coherent, it has a system to it and it is directed at comprehensiveness, which is essential in problem solving in a first income tax course. Other approaches do not have coherence, and they are not directed at comprehensiveness.

It is also suggested that the approach in this article should lead to a deeper understanding of the income tax law regarding receipts or profits. The reason is that the approach is better aligned with the history in the growth of, or introduction of, assessable income provisions and/or the expansion of taxpayers’ tax base, and therefore is more likely “to teach” the context of the relevant charging provisions. Most of the specific assessable income sections and the CGT regime are a response to the narrowness of the income concept, and exempting provisions are a response to the

¹⁰⁷It does not matter much whether the exclusion or exemption of a capital gain or capital loss when the taxpayer acquired the asset before 20 September 1985 is seen as part of the positive or negative criteria. It is probably more convenient to regard the rule as part of the positive criteria because the rule is located in close proximity (same section) to the CGT event rule: see s 104-10(5) for CGT event A1, s 104-25(5) for CGT event C2.

broadness of the income concept. This is part of the context and background to the introduction of these provisions. The key point is that the suggested approach to the charging rules roughly reflects the introduction and development of the charging provisions within the income tax. It is difficult, if not impossible to make this assertion with another less ordered approach.

In regard to the claim that less errors will be made by using the ordered approach, let us consider the examples in Sub-Part 3.1. Most of Examples 1-5 involve the error of applying the incorrect assessable income section to a particular receipt (e.g. subsidy to a business); instead of applying s 6-5, the specific assessable income section was applied. Is the error of applying the incorrect assessable income section significant? In one sense, the answer is no, because the amounts in Examples 1-5 are still included in assessable income.

However, the problem solver is adopting a sub-standard or poor approach to tax problem solving. First, the correct assessable income provision (s 6-5 here) may have a different timing rule to the incorrect provision as to when the receipt is included in assessable income. Secondly, the problem solver is getting into the dangerous and incorrect practice of applying an assessable income section to a transaction when all the criteria for the application of the section are not satisfied. Thirdly, the problem solver may also be adopting an approach to assessable income sections that focuses on the description of a particular receipt. This is dangerous because the great majority of receipts do not have an assessable income provision specifically for them.¹⁰⁸ The income section, which is not limited to particular receipts, is the only non-CGT charging provision that can apply to these, great majority of receipts. The problem solver could get into the habit of limiting his/her focus to assessable income provisions that deal with particular receipts. Fourthly, the problem solver is denying himself/herself the opportunity to appreciate, or at least question, the role of the specific assessable income sections and s 6-5 in regard to the relevant receipt, and thereby losing an opportunity to deepen their understanding of the income tax law.

The sub-standard approach to problem solving is also present in Examples 6 and 7, and therefore most of the criticisms re Examples 1-5 above are also relevant. The error in Example 6 is similar in effect to the errors in Examples 1-5 (i.e. amount included as part of sale proceeds of depreciating asset instead of being included in assessable income under s 6-5, and then excluded from sale proceeds).

Example 7, which contains two examples, involves the problem-solver “heading straight” to the CGT regime. In regard to the first example within Example 7, most times, this will not result in an incorrect answer. But this would be through good luck (i.e. profit is not income), rather than through deliberate and considered application of the tax law by the problem solver. In regard to the second example within Example 7, this will lead to incorrect answers. There will be no “good luck” correction here.

¹⁰⁸The tax legislation would have to be much longer than its already long length.

In Example 8 (sale of main residence), the problem solver has failed to apply the positive criteria within the CGT regime, in particular, CGT event A1, to determine whether a capital gain arises in the first place. Instead, the problem solver has proceeded straight to the main residence exemption regime, which of course invites the assumption that aside from the exemption regime, a taxable situation arises.

Put shortly, it is less likely that the errors in Examples 1-8 would be made if the problem solver adopted the ordering approach suggested in this article.

The error in Example 9 might not end up in an incorrect overall result because the valuation rule under s 21A of the ITAA 1936 might give an amount that roughly equals the s 15-2 amount. Again though, this would be “good fortune” rather than good problem solving. The error involves the problem solver focusing narrowly on the correction to the deficiency identified under the income concept, namely, the non-convertibility doctrine for non-cash benefits. What the problem solver has failed to do is to identify that s 21A only applies to a business taxpayer. It is suggested that had the problem solver also reached a conclusion on the category of income activity when undertaking the s 6-5 analysis, the problem solver might have carried that information into the s 21A analysis, which may have lead to a correct answer. It is true that a comprehensive analysis of s 21A would have picked up the error. However, it is submitted that the problem solver is likely to be more alert to the scope of corrective provisions (s 21A in this example) if he or she has considered the key negative and positive criteria from the ordinary income provision.¹⁰⁹

4.2.2 Employment Relationship

Where there is an employment relationship between the payer (provider) and payee, the starting point should be the FBT regime, and in particular, the definition of a “fringe benefit” in s 136(1) of the FBTA. In other words, the approach should first be to determine the regime under which the benefit is to be taxed (i.e. FBT or non-FBT income tax)¹¹⁰ so that the other regime can be excluded.

If the benefit comes within the definition of a fringe benefit, it will be taxed under the FBTA and the employee recipient will not be assessed on the benefit.¹¹¹ For completeness, if the benefit is an “exempt benefit” under the FBTA,¹¹² then there is no FBT on the benefit but in addition, the employee recipient will not be assessed on the benefit.¹¹³ If however the benefit falls outside the definition of a fringe benefit, and outside the definition of an exempt benefit, then the focus switches to the ITAs (non-

¹⁰⁹Often the suggestion is made that s 15-2 overcomes the non-convertibility doctrine for a business taxpayer in receipt of a non-cash benefit. This is also incorrect because, while s 15-2 does overcome the non-convertibility doctrine, it only does so for a business taxpayer.

¹¹⁰The FBT regime is properly classified as a component part of Australia’s income tax regime. The FBT regime is a tax on “income”, using the term income in its broadest sense, or economic sense. The fact the tax is levied on the provider (employer) of benefits does not undermine this.

¹¹¹Subsection 23L(1) of the ITAA 1936.

¹¹²There are numerous sections in the FBTA that make certain benefits exempt benefits. For example, s 58P: minor and infrequent and irregular small benefits and s 58Z: taxi travel to or from the place of work.

¹¹³Subsection 23L(1A) of the ITAA 1936.

FBT income tax). This means that the approach to the tax rules set out in Sub-Part 4.2.1 above applies.

4.3 Order of Approach to Tax Rules when dealing with Expenses, Outgoings or Losses

4.3.1 Ordered Approach

The following steps are the suggested order of application of the tax rules when dealing with expenses or outgoings. Note also the ordered approach within each regime/section within each step:

1. The general deduction section (s 8-1);
2. Specific deduction conferral sections, or sections that provide a deduction (e.g. s 25-5, 25-25, 25-100, 30-15, 40-25, and 40-880), aside from the cost base of a capital gains tax asset;
3. Deduction denial sections, or sections that withdraw a deduction (or defer a deduction otherwise available in the current income year), that would otherwise satisfy a deduction conferral section (e.g. ss 26-20 and 26-35); and
4. The cost base of a capital gains tax asset.

Importantly, where the problem-solving forum for the course permits (e.g. tutorial; seminar; to a lesser extent, written assignments), it is suggested that all of the above steps are engaged in, even where s 8-1 applies (Step 1) to confer a deduction.

In regard to Step 1, the analysis ought to be comprehensive in the sense that the key positive criteria and the key negative criteria in s 8-1 are considered in turn. The reason is that the specific deduction conferral provisions, deduction denial provisions and the CGT cost base regime correct for deficiencies in the general deduction section (i.e. to narrow or to broad) so that many of the central concepts/criteria (both positive and negative) are adopted or corrected for in specific deduction conferral provisions, deduction denial provisions and CGT cost base provisions. In other words, it is submitted that it is best to have the full picture when completing the s 8-1 analysis and embarking on the analysis in Steps 2 to 4. Again, like the suggestion for receipts, the idea is that where the problem solver has formed a view about the taxpayer's activity under general principles in s 8-1, it is harder for that problem solver to erase or contradict that view when undertaking the analysis under a specific deduction section or CGT cost base rules. And, the key structures in s 8-1 do often form an important part of specific deduction sections and CGT cost base rules (e.g. relevance of expense to income production, capital character of expense, apportionment of expense).¹¹⁴

For example, take a taxpayer that incurs expenditure in opposing the grant of a licence to a new entrant into the taxpayer's business sector.¹¹⁵ The expenditure is capital. If the problem solver also observes or notes when undertaking the s 8-1 analysis that the

¹¹⁴Given that the depreciating asset regime appears to be an exclusive code in regard to deductions on disposal of a depreciating asset (*Australia and New Zealand Banking Group Ltd v FCT* 93 ATC 4238 at 4277-4278), in effect, the Step 1 analysis in this article is by-passed. That is, no deduction is available under s 8-1 where the depreciating asset is sold for less than its cost of purchase.

¹¹⁵These were the facts in *Broken Hill Theatres Pty Ltd v FCT* (1952) 9 ATD 423.

expenditure is sufficiently relevant to the taxpayer's business, the problem solver is likely to bring that relevance conclusion into the s 40-880 analysis and therefore, in all probability, avoid the error of concluding that s 40-880 cannot apply because the expenditure is not related to the business. The problem solver who merely concludes that s 8-1 does not apply because the expenditure is capital will be starting the s 40-880 analysis from scratch. This will not necessarily lead to an error because the problem solver may simply undertake a comprehensive analysis of the s 40-880 business/non-business dichotomy.

A similar approach ought to be taken in regard to Step 2. Many specific deduction conferral sections have a positive requirement(s) and a negative requirement(s). Like the approach to the positive and negative criteria within the general deduction section, it is suggested that the positive and negative requirements of specific deduction conferral sections are analysed in turn.

A systematic approach ought to be taken in regard to Step 3 (deduction denial provisions). Some deduction denial sections or regimes solely contain a deduction denial rule. However, some contain a deduction denial rule but also exceptions to that deduction denial rule. It is suggested that for these regimes, you should start your analysis at the deduction denial rule, and only after that, should your analysis move to the exceptions to the deduction denial rule.

A systematic approach should also be taken in regard to Step 4. That is, the focus should first be on the positive elements of the cost base of a CGT asset that include an expense in the cost base or reduced cost base. From there, the analysis should move to the negative criteria whereby expenses are excluded from the cost base.

4.3.2 Justification for Ordered Approach

The central justification for the suggested approach is essentially the same as that given for receipts above; that is, it is more likely to lead to a correct answer to a tax problem mainly because the approach encompasses a comprehensive analysis to the problem whereby all provisions or regimes or rules within regimes that can govern the tax outcome of the transaction are considered. Indeed, an ordered approach is a higher priority in regard to expenses compared to receipts because of the fewer "mechanisms" built into the expense rules that correct for poor problem solving.

Again, the ordered approach suggested here does not guarantee a correct answer to a tax problem because the problem solver still has to identify the relevant rules, determine the scope of those rules and deal with characterisation issues within those rules. The ordered approach does not assist and is not intended to assist in this regard. Further, the ordered approach will not necessarily be superior to other approaches for all problem solvers because the problem solver using another approach may end up with the required coverage of relevant provisions in any event. For example, a problem solver might commence at the CGT provisions first and conclude that interest expenditure to purchase a rental property does come within the third element of the cost base. Then, he or she "may" work through s 110-45(1B) and note that the expenditure is excluded from the cost base if it is deductible (anti-double counting rule), which may have the effect of pointing the problem solver back to s 8-1 to

analyse whether the interest is deductible. This problem solver may end up at the correct answer, but it is not clear what system the problem solver is employing. The ordered approach in this article is far more coherent, it has a system to it and it is directed at comprehensiveness, which is essential in problem solving in a first income tax course. Other approaches do not have coherence, and they are not directed at comprehensiveness.

Consistent with the point made for receipts, it is suggested that the approach in this article should lead to a deeper understanding of the income tax law regarding expenses. The reason is that the approach is better aligned with the history in the growth or introduction of deduction and cost recognition provisions and deduction denial provisions and therefore is more likely to teach the context of the relevant provisions. Most of the specific deduction provisions and CGT cost base rules are a response to the narrowness of the general deduction section. Deduction denial regimes are a response to the broadness of the general deduction section. This is part of the context and background to the introduction of these provisions. The key point is that the suggested approach to expense rules roughly reflects the introduction and development of corrective deduction provisions within the income tax. It is difficult, if not impossible to make this assertion with another less ordered approach.

In regard to the claim that less errors will be made by using the ordered approach, let us consider the examples in Sub-Part 3.2. Examples 10-13 involve the error of applying a specific deduction or cost recognition rule because the rule identified deals with the relevant expenditure. The specific rule is applied to the exclusion of other rules that may apply to the expense. This approach could only be correct if the legislative intent was to exclude all other deduction and cost recognition provisions, including s 8-1. There is no indication that this was the intent of parliament. Thus, had the problem solver followed the ordered approach suggested, it is far less likely that the errors in Examples 10-13 would have been made.

Example 10 (theft by employee) does not lead to an error in one sense because the taxpayer is obtaining a deduction for the expense and it does not really matter whether that is under s 8-1 or s 25-45. However, by commencing and finishing the analysis at s 25-45, the problem solver is adopting an approach to deduction sections that focuses on the description of a particular expense (loss here). This is dangerous because the great majority of expenses do not have a specific deduction conferral provision for them. The general deduction section, which is not limited to particular expenses, is the only non-CGT cost recognition provision that can apply to these, great majority of receipts. The problem solver could get into the habit of limiting his/her focus to deduction provisions that deal with particular receipts. Another problem with commencing with a specific deduction conferral provision that deals with "theft of money" is to ask, why didn't the problem solver apply another provision that deals with the theft of money, namely s 116-60? In other words, why did the problem solver choose to apply s 25-45, and not s 116-60? It is submitted that this is the problem associated with an approach that focuses on, in the first instance, with rules that deal with a particular expense.

The error in Example 14 involves the problem solver commencing and concluding their analysis at the exception rule to the deduction denial rule, within the deduction denial regime. As a matter of statutory interpretation, the exception to a deduction denial cannot confer a deduction on a taxpayer. Put shortly, this error is far less likely to have occurred if the ordered approach in this article was followed. In particular, if the ordered approach is followed, the problem solver should never elevate a deduction denial exception rule to being a deduction conferral provision.

The errors or failures in Example 15 (i.e. failure to address the requirement in the capital allowance regimes and the fourth and fifth elements of CGT asset cost base that the expenditure must be of a capital nature to come within those regimes/provisions) and Example 16 (i.e. the expenditure fits within a capital allowance regime and/or CGT asset cost base and therefore it must be capital under s 8-1) are far less likely to be made had the problem solver adopted the approach set out in this article. Addressing the revenue-capital issue under s 8-1 at Step 1 and carrying “that picture” into specific deduction conferral sections or cost recognition rules should correct for both of these errors.

4.3.3 Slight Variation where Repair Expenditure involved

Where the taxpayer incurs expenditure in “fixing something up”, it is suggested that the order of application of the tax rules should roughly be the same as that set out above, except that s 25-10 should displace s 8-1 at Step 1. Indeed, it is suggested that the problem solver ignore s 8-1 in regard to repair expenditure transactions. The main reason is that the key structural aspects in s 25-10 are, by and large, the same as the key structural aspects of s 8-1 and that therefore the same deductible or non-deductible outcome should arise from given facts.¹¹⁶ The common structural aspects are: (a) purpose of producing assessable income¹¹⁷ (b) apportionment of expenditure into deductible and non-deductible parts where repaired asset only used partly to produce assessable income¹¹⁸ and (c) capital expenditure is not deductible.¹¹⁹ And, even though the three capital limbs (i.e. initial repairs, improvement, replacement of an entirety)¹²⁰ were developed in the context of the repair section, it is submitted that those concepts

¹¹⁶For the most part, the ATO agrees with this view. At paragraph 74 of Taxation Ruling TR 97/23, the ATO states:

“Generally speaking, section 8-1 produces the same result as section 25-10 in relation to the deductibility of repair costs. Section 8-1 has its own tests for deductibility. There may be occasions, however, where section 8-1 allows a deduction for repair expenditure that would otherwise not be deductible under section 25-10. Section 8-1 might allow a deduction, for example, after a taxpayer ceases to hold, etc., property for income purposes even though section 25-10 would not allow a deduction (see *Placer Pacific Management Pty Ltd v FC of T* 95 ATC 4459; (1995) 31 ATR 253)”.

¹¹⁷Subsection 25-10(1).

¹¹⁸Subsection 25-10(2).

¹¹⁹Subsection 25-10(3).

¹²⁰Strictly speaking (i) the improvement concept and (ii) the replacement of an entirety concept, deny the expenditure being a repair. However, the analysis of these two types of situations will usually result in the expenditure also being of a capital nature.

would have been developed under the general deduction section, in the absence of a repair section.¹²¹

In addition, because of the type of expenditure involved, a narrower range of specific deduction conferral sections will be relevant at Step 2. The suggested order therefore is:

1. The repair section (s 25-10);
2. Deduction conferral sections, or sections that provide a deduction (e.g. s 40-25, s 43-10), aside from the cost base of a capital gains tax asset;
3. Deduction denial sections, or sections that withdraw a deduction; and
4. The cost base of a capital gains tax asset.

The error in Example 17 (i.e. no thought given to including expenditure in the “cost base” recognition rules under Division 40 or Division 43 once the expenditure has been found to be a “capital repair”) is far less likely to be made had the suggested order been followed.

5. CONCLUSION

The tax rules studied in a first income tax course suffer from a number of deficiencies including overlap in assessable income provisions, overlap in deduction or cost recognition provisions, a general lack of express ordering rules and the presence of regime co-ordination rules that are hidden. In spite of this, the core tax rules do have a conceptual structure and considerable coherence. There is a real need therefore for a problem solving approach that reveals the conceptual structure of and the coherence within the tax rules so that deficiencies in the legislation do not undermine good problem solving.

With the aim of revealing the conceptual structure of the main tax rules, coherence of the rules and the interaction between the main tax rules, this article did set out the nature of the main tax rules (Part 2). From there, the article gave a number of examples of defective problem solving from disordered approaches to the application of the main tax rules to given facts (Part 3). These disordered approaches took no account of the conceptual structure and the coherence embedded within the main tax rules. Part 4 then introduced the author's ordered approach to the application of the tax rules to problem situations. Largely against the background of the facts in the examples in Part 3, it was demonstrated that the author's ordered approach is likely to consistently lead to better problem solving compared to disordered approaches. The reasons for this is that the author's ordered approach takes account of the conceptual structure of the tax rules and the coherence within those rules, and it is the only approach that has comprehensiveness as a main element of the problem solving process.

¹²¹The discussion of the relevant principles in repair cases like *FCT v Western Suburbs Cinemas Ltd* (1952) 9 ATD 452 and *W Thomas & Co v FCT* (1965) 14 ATD 78 in large part, draws on the revenue-capital dichotomy.

APPENDIX

This appendix sets out the topics covered in the Taxation Law course taught by the author. The topics are very similar to those studied in other Australian income tax law courses. It is possible though that the coverage below is narrower than that at other universities because the author has, within the constraints of the accreditation requirements of the various professional accounting bodies, taken the decision to pursue depth across a narrower range of topics (i.e. the well over the lake).

SEMINAR ONE

- 1.1 Course Administration
- 1.2 Tax Policy
- 1.3 Administration of Australia's Income Tax Regime
- 1.4 Income Tax Formula and Calculation of Tax Payable
- 1.5 Jurisdictional Aspects of Australia's Income Tax
- 1.6 Fundamental Income Tax Principles
- 1.7 Approach to Solving Problems in Taxation Law

SEMINAR TWO

- 2.1 Receipts and Benefits from Personal Exertion: An Overview
- 2.2 Income as a Reward from Personal Exertion, or Product of Personal Exertion
- 2.3 Statutory Additions to Judicial Concept of Income from Personal Exertion
- 2.4 Integrating the Various Personal Exertion Regimes

SEMINAR THREE

- 3.1 Capital Receipts in Context of Reward for Personal Exertion
- 3.2 Introduction to the Capital Gains Tax
- 3.3 Receipts and Benefits from a Business: An Overview
- 3.4 Existence of a Business or a Money-Making Endeavour
- 3.5 Normal Proceeds of Business/Ordinary Course of Business/Normal Incident of Business/Revenue or Structural Assets of Business

SEMINAR FOUR

- 4.1 Isolated Business Ventures/Profit Making Undertakings or Schemes
- 4.2 Receipts and Benefits from Property: An Overview, and a Problem/Opportunity
- 4.3 Rent/Lease Returns
- 4.4 Interest
- 4.5 Compensation Receipts Principle: An Overview
- 4.6 Compensation Receipts Principle in Context of Personal Services
- 4.7 Compensation Receipts Principle in Business Context
- 4.8 Compensation Receipts Principle in Context of Property Income
- 4.9 Factorial Income Principle

SEMINAR FIVE

- 5.1 History of Capital Gains Taxation in Australia
- 5.2 Role of Capital Gains Taxation within the Income Tax Assessment Acts
- 5.3 Broad Outline of Australia's Capital Gains Tax

5.4 Paradigm/Model CGT Framework: Essential Elements of First Charging Provision of the Capital Gains Tax

5.5 Assets, Exempt Assets and Asset Classification

5.6 Acquisition and Disposal (CGT Events)

5.7 Timing Issues

5.8 Calculating Gain or Loss

5.9 Second Charging Provisions of the CGT Regime

5.10 Determining Taxable Gain and Integration with Non-CGT Provisions

SEMINAR SIX

6.1 Overview of Expense Recognition under the Income Tax Assessment Acts

6.2 Deductions: General Principles

6.3 Relevant Expenditure: Test(s) of Deductibility

6.4 Expense Apportionment

SEMINAR SEVEN

7.1 Personal/Non-Personal Boundary Expenditure

SEMINAR EIGHT

8.1 Contemporaneity Principle

8.2 Revenue/Capital Boundary

8.3 Capital Allowance Regimes

SEMINAR NINE

9.1 Other Deduction Conferral Provisions

9.2 Deduction Denial Provisions

9.3 Tax Accounting: An Overview

9.4 Tax Accounting for Trading Stock

SEMINAR TEN

10.1 Taxable Income obtained through “Entities”: An Overview

10.2 Taxation of Taxable Income obtained through a Partnership: An Overview

10.3 Existence of a Partnership

10.4 Taxation of Partnership’s Taxable Income/Tax Loss

10.5 Transactions between Partners, Transactions between Partners and “The Partnership” and Transactions between Partnership and Third Parties

10.6 Taxation of Taxable Income obtained through a Trust Estate: An Overview

10.7 Existence of a Trust Estate/Trust

10.8 Taxation of Trust Estate’s Taxable Income

SEMINAR ELEVEN

11.1 Taxation of Taxable Income obtained through a Company: An Overview

11.2 Existence of a Company

11.3 Classification of Companies for ITAA Purposes: Private or Public

11.4 Calculation of Companies’ Taxable Income or Tax Loss, and Tax Payable by Companies

11.5 Imputation System: Company’s Perspective

- 11.6 Distributions to Shareholders
- 11.7 Distributions to Natural Person Shareholders
- 11.8 Distributions to Corporate Shareholders

SEMINAR TWELVE

- 12.1 Tax Avoidance Defined and Conditions that Facilitate Tax Avoidance/Tax Planning
- 12.2 Judicial and Legislative Responses to Tax Avoidance/Tax Planning
- 12.3 Australia's Goods and Services Tax: An Overview
- 12.4 Net Amount Formula under the GST Act
- 12.5 Notion of an Entity under the GST Act
- 12.6 Notion of a Taxable Supply
- 12.7 GST Free Supplies
- 12.8 Input Taxed Supplies
- 12.9 Notion of a Creditable Acquisition
- 12.10 Broad Operation of Fringe Benefits Tax Regime
- 12.11 Expense Payment Fringe Benefits
- 12.12 Interaction between GST, Income Tax and Fringe Benefits Tax