THE TAX INSTITUTE

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Australian Taxation Office
Public Advice and Guidance Panel

By email: James.Beeston@ato.gov.au

Dear James,

TR 2019/D6 - Income tax: application of paragraph 8-1(2)(a) of the Income Tax Assessment Act 1997 to labour costs related to the construction or creation of capital assets

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office in relation to TR 2019/D6 - Income tax: application of paragraph 8-1(2)(a) of the Income Tax Assessment Act 1997 to labour costs related to the construction or creation of capital assets (**TR 2019/D6**).

Summary

The Tax Institute disagrees with the comments in relation to apportionment of labour costs in TR 2019/D6. In our opinion, the discussion of apportionment in TR 2019/D6 needs to be revised. We have outlined some suggested amendments below.

Detailed Comments

TR 2019/D6 requires apportionment of labour costs in some circumstances. In this regard, paragraphs 8 and 9 provide:

> *"8. Whether capital asset labour costs are incurred specifically for constructing or creating capital assets is ordinarily to be ascertained at the time the loss or outgoing is incurred, and so:*
>
> - *costs in relation to an employee may be initially on capital account and later change to be on revenue account (and vice versa), and*
> - *employees may be specifically employed for both constructing or creating capital assets and other duties, in which case apportionment of the losses or outgoings is called for.*
>
> *9. Apportionment is to be conducted on a fair and reasonable basis."*

Further, paragraphs 61 and 62 provide:

> *"61. Section 8-1 prevents a deduction for an amount to the extent that it is capital or capital in nature. If the essential character of a loss or outgoing can be said to be in part on capital account, then the words 'to the extent that' require apportionment on a fair and reasonable basis.[1] Hill J in Goodman Fielder made the following observation in relation to the apportionment of salary and wages (at pages 44–45):*
>
> > *In between, there will be cases where it may be difficult to determine whether expenditure should properly be regarded as on capital account or as on revenue account. Each case will depend upon its facts but the answer will not be derived merely by counting the number of hours in which the employee is engaged in activities which themselves may be said to involve matters of capital.*
>
> *62. Whilst merely counting the number of hours an employee is engaged in activities is not the sole answer to apportionment, it may nonetheless be the method ultimately adopted. In other words, a fair and reasonable basis requires all relevant circumstances to be considered, but if, after having done so, time spent on capital activities fairly reflects the essential character of part of the relevant outgoing, it may be the most appropriate basis of apportionment. This does not discount other methods of apportionment which may be reasonable in the circumstances. For example, employee costs spent on supporting activities directly related to the construction or creation of capital assets may be able to be demonstrated to be a function of direct employee capital activities, and so their costs apportioned by reference to that ratio or relationship."*

The analysis in paragraphs 61 and 62 underpins the approach taken with respect to apportionment throughout TR 2019/D6 and in particular in paragraph 30 of Example 5.

In our opinion, the discussion of apportionment in TR 2019/D6 has omitted crucial elements of the judgment of Hill J in *Goodman Fielder Wattie Ltd v Commissioner of Taxation* [1991] FCA 264. Specifically, we refer to the highlighted section below which was omitted from TR 2019/D6:

> "*On the other hand, where an employee is employed and engaged in activities which are part of the recurring business of a company, the fact that he may, on a particular day, be engaged in an activity which viewed alone would be of a capital kind, does not operate to convert the periodical outgoing for salary and wages into an outgoing of a capital nature. In between, there will be cases where it may be difficult to determine whether the expenditure should properly be regarded as on capital account or as on revenue account. Each case will depend upon its facts but the answer will not be derived merely by counting the number of hours in which the employee is engaged in activities which themselves may be said to involve matters of capital. Further, it will be necessary to determine whether the essential character of the expenditure is that it is a working expense. If it is, then it will ordinarily be on revenue account. In the present circumstances, however, I think that the salary of Dr Watson can be seen to be clearly part of the recurring outgoings of the company on its business*

activities. The fact that he spent some time dealing with patent attorneys does not, in my view, convert that expenditure to expenditure of a capital nature." (highlights added)

In our opinion, by omitting the highlighted section above, paragraph 61 of TR 2019/D6 has taken the extract from Hill J's judgment in *Goodman Fielder Wattie* out of context. Contrary to the position stated in paragraph 61, the question that Hill J was considering was not in relation to the apportionment of salary and wages but rather whether expenditure that was of a kind that normally was of an income character would retain that character notwithstanding that during some period of ordinary employment the employees were engaged on activities which looked at on their own were on capital account (at [91]). In addressing the question of characterisation (not apportionment), Hill J stated that it involves a question of fact and degree and said (at [92]).

> *"In between, there will be cases where it may be difficult to determine whether the expenditure should properly be regarded as on capital account or as on revenue account. Each case will depend upon its facts but the answer will not be derived merely by counting the number of hours in which the employee is engaged in activities which themselves may be said to involve matters of capital. Further, it will be necessary to determine whether the essential character of the expenditure is that it is a working expense. If it is, then it will ordinarily be on revenue account".*

A correct understanding of Hill J's judgment in *Goodman Fielder Wattie*, impacts the analysis in TR 2019/D6 on apportionment generally, not just in paragraphs 30 and 61-62.

Hill J appears generally ***against*** apportioning salaries or wages between revenue and capital account. Hill J clearly considers it reasonable to treat as capital the remuneration of an employee who is exclusively engaged ("employed for the specific purpose") in capital matters.

The Institute considers that the Commissioner's position in paragraph 8 that an employee's costs may change from capital account to revenue account from time to time is not entirely consistent with Hill J's position, which determines the essential character of an employee's costs (ie as revenue or capital) based on the principal or predominant activities performed by the employee (ie whether such activities relate to a working expense or expenditure of a capital nature) notwithstanding that some part of the employee's time may be spent on activities that taken in isolation might have a different character. Further, ***apportionment*** as envisaged in paragraph 62 is ***not*** consistent with the comments of Hill J before and after the passage quoted in paragraph 61.

Hill J's default expectation is clearly that salaries or wages would be on revenue account ("wages [are] expenditure … of a kind that normally is of an income character") unless there were some clear and exclusive involvement of the employee in affairs of capital ("Where a person is ***employed for the specific purpose*** of carrying out an affair of capital, the mere fact that that person is remunerated by a form of periodical outgoing would not make the salary or wages on revenue account" [emphasis added]).

Hill J even acknowledges that he was not aware of any case where the matter of apportionment was addressed and resorted to referring to an academic text which remarked that the UK Revenue did not normally seek to deny a deduction on the basis that wages were on capital account. Therefore, in our opinion, the apportionment position being taken by the Commissioner does not appear to have any basis in judicial authority.

For the above reasons, we consider that the paragraphs dealing with apportionment in TR 2019/D6 need to be redrafted along the lines that where the essential character of the relevant wages is an "ordinary recurrent expenditure" of the taxpayer, they are on revenue account, and that where the particular employee

concerned was “employed for the specific purpose of carrying out an affair of capital”, that employee’s wages would be on capital account. We have discussed redrafting these paragraphs in more detail below.

Apportionment – suggested amendments to TR 2019/D6

In *Ronpibon Tin NL and Tongkah Compund NL v Federal Commissioner of Taxation* 78 CLR 47 (***Ronpibon***), the High Court identified at least two broad kinds of expenses that require apportionment:

- One kind consisting of undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases, the High Court said it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services; and
- The other kind of apportionable items consisting of those involving a single outlay or charge which serves both objects indifferently, with directors' fees being given as an example. In these cases, the High Court said there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income and noted that the outlay is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects.

Unfortunately, TR 2019/D6 is drafted such that in all cases involving the apportionment of expenses, apportionment is to be undertaken on a fair and reasonable basis, for example:

- "Apportionment is to be conducted on a fair and reasonable basis" (paragraph 9); and
- "If the essential character of a loss or outgoing can be said to be in part on capital account, then the words ‘to the extent that’ require apportionment on a fair and reasonable basis" (paragraph 61).

The footnotes to paragraphs 9 and 61 indicate that *Ronpibon* is relied upon as the basis for the statements made.

As such, TR 2019/D6 has not considered how the first broad kind of apportionable items of expenditure identified in *Ronpibon* should be considered. In the Institute's view, TR 2019/D6 should be revised so that it is consistent with the principles espoused by the High Court in *Ronpibon* in relation to the apportionment of expenses.

Further, *Ronpibon* also stands for the proposition that in applying the tests of deductibility in ss51(1) *ITAA 1936*, as the general deduction provision then was, "separate and distinct items of expenditure should be dealt with specifically" (at [58]). By contrast, and in particular, paragraph 30 of TR 2019/D6 appears to support the position that all of the costs being considered (referred to as "combined costs" in the draft ruling) should first be aggregated and then apportioned using the best information available. As such, the Commissioner should revise paragraphs 27-30 to ensure consistency with the decision in *Ronpibon*.

In relation to apportionment generally and the use of accounting principles, we draw the Commissioner's attention to the decision of the High Court in *BP Refinery (Kwinana) v Federal Commissioner of Taxation [1961] ALR 52; (1960) 12 ATD 204; (1960) 8 AITR 113*. While this case, dealt with the allocation of indirect costs (or on-costs) in order to determine the appropriate amount of costs for purposes of the depreciation provisions of the *ITAA 1936*, it is nevertheless instructive in relation to matters addressed in the draft ruling for two reasons. The first is in relation to the broad support it gives to the use of sound accountancy principles in situations where apportionment of expenses is required. The second is in relation to the cautionary words proffered by the High Court in relation to how far one should go with respect to obtaining cost information. In this respect the High Court cautioned against chasing the rainbow of absolute accuracy beyond the point at which the practical accountant would stop.

In light of the above, and in addition to concerns already expressed, paragraph 30 of TR 2019/D6 should also be revised because it goes beyond the point at which the practical accountant would stop. In a similar vein, paragraph 27 of TR 2019/D6 should be revised because it sets out the facts upon which the approach set out in paragraph 30 is based.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Angie Ananda, on 02 8223 0050.

Yours faithfully,

Peter Godber
President