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Apportionment of Dual-Purpose Expenses

Abstract

This article examines a particular type of dual-purpose expense – one which can be linked both to the derivation of assessable income and to the generation of a private benefit. On what basis should a taxpayer be able to claim a deduction for such an expense? Significant difficulty and uncertainty underlie the apportionment process that is applied to such an expense by the courts, the Administrative Appeals Tribunal and the Australian Taxation Office. The process provides little practical guidance to taxpayers on how to apportion dual-purpose expenses. In addition, a tension exists between the apportionment process and the threshold issue of characterisation or ‘relevance’ of dual-purpose expenses. This article examines these issues and suggests some clear principles that should be applied to the task of deducting dual-purpose expenses of this kind.

Keywords

dual-purpose expenses, ATO, apportionment, assessable income

APPORTIONMENT OF DUAL-PURPOSE EXPENSES

NICHOLAS AUGUSTINOS*

This article examines a particular type of dual-purpose expense – one which can be linked both to the derivation of assessable income and to the generation of a private benefit. On what basis should a taxpayer be able to claim a deduction for such an expense? Significant difficulty and uncertainty underlie the apportionment process that is applied to such an expense by the courts, the Administrative Appeals Tribunal and the Australian Taxation Office. The process provides little practical guidance to taxpayers on how to apportion dual-purpose expenses. In addition, a tension exists between the apportionment process and the threshold issue of characterisation or ‘relevance’ of dual-purpose expenses. This article examines these issues and suggests some clear principles that should be applied to the task of deducting dual-purpose expenses of this kind.

This article focuses on expenses that have a particular dual-purpose. On the one hand, the expense leads to gaining assessable income. On the other, the expense also generates a private benefit, such as the satisfaction of a personal consumption preference. For example, the payment of hotel accommodation for a taxpayer and his or her spouse where that accommodation has been arranged as part of overseas travel, that is both relevant to the taxpayer’s employment and the taxpayer and his or her spouse’s enjoyment.

Given the expense has a dual-purpose, should the taxpayer be entitled to claim a deduction for the entire expense? If the taxpayer should not be entitled to claim a deduction for the entire expense, on what basis should the taxpayer apportion the deduction? This article examines the decisions of the courts and the Administrative Appeals Tribunal (‘AAT’), as well as various Australian Taxation Office (‘ATO’) rulings, to ascertain whether these precedents offer any practical guidance to taxpayers on how to apportion this kind of dual-purpose expense. The article finds that apportionment, as applied by the courts and the AAT, is a very loose and subjective process which offers little, if any, practical guidance to taxpayers on how to apportion dual-purpose expenses. At best, certain underlying principles, which offer some general guidance to taxpayers on how to apportion, can be extracted from

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these decisions. There is an obvious need for greater clarity in the enunciation of these principles by the courts and the AAT.

In the context of dual-purpose expenses, a clear inconsistency exists between apportionment as applied by the courts, the AAT and the ATO and apportionment as recommended by the late Professor RW Parsons in his text *Income Taxation in Australia*. In Parsons' view, a tension exists between the apportionment process and the threshold issue of characterisation or 'relevance' of dual-purpose expenses. He consistently points out, 'apportionment ought not to be used as a way of expressing a doubt about relevance'.¹ This article looks at a number of apportionment decisions of the courts and the AAT in light of this recommendation and suggests certain key questions requiring further consideration and clarification.² Should we accept the Parsons approach? If we do, we cut-through a significant part of the administrative difficulty underlying the apportionment process as currently applied to dual-purpose expenses.

Section 8-1 ITAA97

According to sub-section 8-1(1)(a) of the *Income Tax Assessment Act 1997* (Cth) ('ITAA97'), a loss or outgoing is deductible 'to the extent that it is incurred in gaining or producing assessable income'. Sub-section 8-1(2)(b) provides 'you cannot deduct a loss or outgoing under this section to the extent that it is a loss or outgoing of a private or domestic nature'. How are these sub-sections to be applied to the relevant dual-purpose expenses considered in this article? In particular, in the context of dual-purpose expenses, how are the words 'to the extent that' to be interpreted? An ordinary, prima facie reading of these sub-sections suggests that apportionment only is required, as the apportionment process itself should identify that part of the dual-purpose expense that is linked to the derivation of assessable income and should separate expenses that generate the private benefit. A deduction could thus be granted for the expense linked to the derivation of assessable income. Therefore, in applying s 8-1 to dual-purpose expenses, the application of the High Court decision in *Ronpibon Tin* (1949) 78 CLR 47 (discussed below) provides our apportionment methodology.

¹ RW Parsons, *Income Taxation in Australia* (Lawbook Co, Sydney, 1985) 8.51, 8.85, 8.88 and 9.11.

² Professor Parsons' comments were made in 1985 and many of the cases considered in this article were decided at a later date. Nevertheless, despite the constantly developing nature of Australian tax law, it is appropriate to revisit the views put forward by Professor Parsons, which remain relevant to the on-going development of tax policy concerning the apportionment of dual-purpose expenditure.

The application of s 8-1 to dual-purpose outgoings, however, is not such a simple matter. Section 8-1 follows closely the language previously used in s 51(1) of the *Income Tax Assessment Act 1936* (Cth) and the cases and academic commentary considering that section are relevant. According to Parsons,³ in the context of dual-purpose expenses, s 51(1) does not raise an issue of apportionment alone. A separate issue of characterisation or 'relevance' of the expense must also be considered.

Relevance⁴

A consideration of the apportionment of a dual-purpose outgoing does not occur in a vacuum. Consideration must take place in the context of a characterisation of the dual-purpose outgoing. Is the outgoing properly characterised as expenditure 'wholly or partly incurred in gaining or producing assessable income?'⁵ Parsons makes clear that the process of characterising outgoings is separate to apportionment. According to Parsons,⁶

It is the view of this Volume that where an issue is raised as to the relevance of an expense, a decision to compromise by apportioning and allowing a deduction of part of the expense is not appropriate. In circumstances such as *Magna Alloys & Research Pty Ltd* (1980) 80 ATC 4542, if the board of directors is moved in part by a purpose of conferring a gratuitous benefit on the officers of the company – a benefit that is not a reward for services – it is not appropriate to allow a deduction of some part of the expense. A decision must be made as to the whole

³ Ibid 8.85.

⁴ For further discussion on relevance and characterisation of outgoings see: R H Woellner, S Barkoczy, S Murphy, C Evans and D Pinto, *Australian Taxation Law* (CCH, 22nd ed, 2012) chapter 10; P Burgess, G S Cooper, M Stewart and R J Vann, *Cooper, Krever & Vann's Income Taxation Commentary and Materials* (Thomson Reuters, 7th ed, 2012) chapter 7; LexisNexis *Halsbury's Laws of Australia* (at 29 February 2012) 405 Taxation and Revenue, IV Tax Deductions, (2) General Tax Deduction Provision [405-8085] – [405-8110]; E J Teo, 'Australia's Largest Tax Case Revisited: A Nail in the Coffin for the Objective Approach to Determining the Deductibility of Expenses' (2005) 8 *Journal of Australian Taxation* 2, 328; A Blaikie, 'Section 8-1: making certain that you receive what you are entitled to' (Paper presented at the Taxation Institute of Australia National Division Conference, 6 April 2006); M Friezer, 'Tax Forum: Manoeuvring the Maze – Update on Section 8-1' (Paper presented at the Taxation Institute of Australia NSW Division Conference, 24 May 2007); G O'Shaughnessy and M Clough, 'Case Law Developments in Section 8-1' (Paper presented at the Taxation Institute of Australia VIC Division Conference, 8-10 October 2009); M Friezer, 'Update on Deductibility Under Section 8-1' (Paper presented at the Taxation Institute of Australia NSW Division Conference, 18 May 2010).

⁵ *Fletcher v FCT* (1991) 173 CLR 1, 17.

⁶ Parsons, above n 1, 9.11.

expense. An apportionment would simply express a doubt about relevance: it would not identify an element within the expense that is relevant to income derivation.

This comment makes it clear that, in Parsons' view, when dealing with a dual-purpose expense, we should not be quick to apply an apportionment process and grant a deduction for only part of the expense. The question of relevance must first be determined by assessing the expense as a whole. Is the whole of the expense regarded as relevant to income derivation?

Although this is the approach that Parsons suggests should be adopted in principle, it is interesting to note that in many AAT and Board of Review decisions considered for the purposes of this article, this approach was not implemented.⁷ When faced with dual-purpose expenses the tribunal did not first assess the relevance of the expense as a whole but simply made a determination on apportionment. In some instances, this approach was taken because relevance had already been conceded by the Commissioner and this left apportionment as the only matter to be ruled upon.⁸ Only in the case of *Pitcher v DFC of T* 98 ATC 2190 did Senior Member Block refer to the Parsons approach.⁹

Despite the lack of implementation in tribunal decisions, if we follow the Parsons approach, a critical question would arise. Given that the expense clearly has a private benefit as one of its purposes, in what circumstances should we regard the expense as having been incurred wholly or partly in gaining or producing assessable income?

From a logical perspective, the relevance threshold is satisfied only if out of the two purposes served by the expense it is the derivation of assessable income that constitutes the dominant purpose of the expense.¹⁰ In the majority of AAT and Board of Review decisions considered in this article, the question of dominant purpose of the dual-purpose expense was not considered. However, these decisions did not distinguish (or were not required to distinguish) the relevance question from the

⁷ See, for instance, *Case U5* 87 ATC 124 and *Case S12* 85 ATC 165 and the decisions referred to under the section headed 'Apportionment Cases'.

⁸ *Case R2* 84 ATC 106, *Case V15* 88 ATC 177 and *Case S80* 85 ATC 589.

⁹ 98 ATC 2190, 2196. Although Senior Member Block referred to Parsons, he made it clear that to the best of his knowledge there were no judicial pronouncements which favoured the propositions advanced by Parsons. Accordingly, he did not follow previous precedents when making his decision.

¹⁰ Parsons applies a dominant purpose test when considering the relevance of dual-purpose professional/entertainment expenses, Parsons, above n 1, 8.85.

apportionment question. Only in *Re Peter Lenten* and *Pitcher*, the AAT referred to a dominant purpose test in the assessment of the question of relevance.¹¹

Apart from these AAT decisions, there is some limited guidance from the Australian Taxation Office. In taxation ruling TR 92/8,¹² some consideration is given to the apportionment of self-education expenses when they serve both the purpose of gaining or producing income and an incidental private purpose. Paragraph 36 of the ruling makes clear that,

when determining the characterisation issue for self education expenses, we believe that it is, at the least, a relevant matter to consider whether a non income-producing purpose was the dominant purpose for the incurring of the expenses.

The understanding that the relevance of dual-purpose expenses should be assessed according to their dominant purpose is contradicted by the Federal Court case of *FCT v Studdert* (1991) 33 FCR 75. That case involved a Qantas flight engineer who sought a deduction for expenses incurred on light aircraft flying lessons leading to a private pilot's licence. Hill J found that the expenses had a dual purpose. On the one hand, the taxpayer undertook the lessons to become better equipped to perform his skilled job as a flight engineer leading to promotion and increased income. On the other hand, the lessons were undertaken with a view to a possible application for retraining as a flight officer. The first purpose was clearly linked to the derivation of assessable income. The second purpose was a non income-producing purpose. According to Hill J, in determining the essential character of the expenses,¹³ it is irrelevant whether the second purpose is dominant or not. As long as one of the purposes of the expenses relates to the derivation of income, that is enough to resolve the characterisation issue.¹⁴

¹¹ *Re Peter Lenten and Commissioner of Taxation* AAT [2008] BC200802369 [34]; *Pitcher v DFC of T 98* ATC 2190 2197.

¹² Australian Taxation Office, *Income Tax: Deductibility of Self Education Expenses*, TR 1992/8, 17 September 1992. Although TR 92/8 has been withdrawn and replaced by TR 98/9 (Australian Taxation Office, *Income Tax: Deductibility of Self-Education Expenses Incurred by an Employee or a Person in Business*, TR 1998/9, 17 June 1998), the comments made on the characterisation issue are of particular relevance to the discussion in this section of the article.

¹³ The question of whether an expense (dual-purpose or otherwise) has sufficient nexus to the derivation of assessable income is determined by application of an 'essential character' test. This article aims to highlight, however, that there is a problem in the way nexus issues are determined by the courts and the AAT in a dual-purpose context.

¹⁴ 33 FCR 75, 80-81.

We are therefore faced with two possible options when assessing the relevance of dual-purpose expenses. One option is to adopt Hill J's approach, regarding the relevance threshold as being satisfied by the mere fact that one of the purposes of the expense relates to the derivation of income. The other option is to apply a dominant purpose test, regarding the expense as being relevant only if the derivation of assessable income constitutes the dominant purpose. In the context of dual-purpose expenses, it is the dominant purpose test which is more consistent with the approach recommended by Parsons of assessing the relevance of the whole expense.¹⁵

In TR 92/8, the ATO points out that it is not convinced by Hill J's approach. According to the ATO,¹⁶

to the extent that his Honour might be interpreted as suggesting that, when determining the characterisation issue for self education expenses, it is irrelevant to consider whether a non income-producing purpose was the dominant purpose for the incurring of the expenses, we believe that that view is not supported by *Fletcher & Ors v FCT*. *Fletcher & Ors* 173 CLR 1 is a High Court decision and would clearly override *Studdert*.

According to the joint judgment of Mason CJ, Brennan, Deane, Dawson, Toohey, Gaudron and McHugh JJ (173 CLR 1, 17-18):

In that regard and in the context of the sub-section's clear contemplation of apportionment, statements in the cases to the effect that it is sufficient for the purposes of s. 51(1) that the production of assessable income is "the occasion" of the outgoing or that the outgoing is a "cost of a step taken in the process of gaining or producing income" are to be understood as referring to a genuine and not colourable relationship between the whole of the expenditure and the production of such income.

This extract from the joint judgment in *Fletcher & Ors* confirms the High Court's support for an approach that considers the relevance of the whole expense. The ATO argues however, that the judgment also supports the application of a dominant-purpose test when assessing the relevance of dual-purpose expenses. This argument is not entirely convincing as the joint judgment acknowledges that the question of 'dominant purpose' was not explored before the High Court.¹⁷ It is submitted that this issue awaits further clarification in a subsequent decision.¹⁸

¹⁵ Parsons, above n 1, 8.85.

¹⁶ TR 92/8, above n 12, 35.

¹⁷ 173 CLR 1, 24.

¹⁸ The application of a dominant purpose test in the context of a relevance assessment relates to the 'legal right approach/purposive approach' question discussed in R H Woellner (et al), above n 4, [10-210] and in P Burgess (et al), above n 4, [7.430]. It is the

The court and tribunal decisions examined in this article reveal that deductibility involves a two-stage process (whereby relevance and apportionment are considered as separate issues). This principle is very much the settled orthodoxy. Parsons, however, argues that, even in the case of dual-purpose expenses, apportionment does not follow relevance. If the expense is found to be relevant, then the expense is deducted in full.¹⁹ If it is not relevant, no deduction is granted at all. Also in *Studdert*, no question of apportionment arose.²⁰ Hill J allowed a deduction for the entire dual-purpose expense having found the expense to be relevant.²¹ So where does that leave *Ronpibon Tin* and the process of apportionment? The overwhelming majority of court and tribunal decisions which are the focus of this article have purportedly followed the *Ronpibon Tin* precedent and apportioned dual-purpose expenses. There is, however, an inconsistency between how *Ronpibon Tin* has been applied by the courts and tribunals and how Parsons recommends that this case should be applied. That inconsistency is explored in more detail in the next section of this article.

Principles of Apportionment and the Apportionment Process²²

The principle of apportionment, which underlies s 8-1 of the ITAA97, was interpreted in the High Court case of *Ronpibon Tin NL v FCT*:

there are at least two kinds of items of expenditure that require apportionment. One kind consists in undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or

view of this article that the legal right approach/purposive approach question arises in the context of a different type of dual purpose expense – one where the dual-purpose relates to the realisation of an apparent benefit (the derivation of taxable income) and a tax benefit (a reduction in the taxes ultimately payable). Whilst the ‘legal right approach/purposive approach’ distinction can be drawn in the context of an assessable income/tax minimisation dual-purpose expense, it does not translate to an analysis of the assessable income/private benefit dual-purpose expenses which are the focus of this article.

¹⁹ Parsons, above n 1, 9.2, 8.85 and 8.51.

²⁰ 33 FCR 75, 76.

²¹ Hill J clearly acknowledges that a deduction for the entire dual-purpose expense should not be denied even where the non-income producing purpose is dominant (33 FCR 75, 80).

²² For further discussion on apportionment and the apportionment process see: R H Woellner (et al), above n 4, 10-200; P Burgess (et al), above n 4, 7.410; K Sadiq (et al), *Principles of Taxation Law* (Thomson Reuters, 5th ed, 2012), 12.270; *Australian Master Tax Guide* (CCH, 51st ed, 2012) 16-070fj; J W Durack, ‘Deductions for Personal Expenditure – Having your Cake and Eating it Too’ (1994) 23 *Australian Tax Review* 205; D Lockie and W Ngo, ‘Apportionment of Deductions Post FCofT v Firth’ (2002) 5 *The Tax Specialist* 5, 254.

producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services. The other kind of apportionable items consists in those involving a single outlay or charge which serves both objects indifferently. Of this directors' fees may be an example. With the latter kind there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income. It is an indiscriminate sum apportionable, but hardly capable of arithmetical or rateable division because it is common to both objects. In such a case the result must depend in an even greater degree upon a finding by the tribunal of fact.²³

Based on this statement from the High Court, a few general conclusions can be drawn on assessing the deductibility of dual-purpose outgoings. The first step is to work out whether the outgoing comes within the first or the second kind of apportionable outgoing, as identified in *Ronpibon Tin*. The second step is to apply the relevant apportionment process which corresponds to each kind of apportionable outgoing.

For the first kind of apportionable outgoing, the apportionment process can be applied with relative precision. The apportionment process is simply a matter of dividing the expense and 'tracing' those parts linked to the generation of assessable income. An example of such an apportionable outgoing would be the cost of a mobile phone which is used for both private and business purposes. As detailed records are kept of the cost of individual calls, it would be possible (and, perhaps, not too impractical) to extract from a monthly mobile phone bill that part which relates to income generation and to allow a deduction for that part of the total cost.²⁴

Where the separate outgoing is relevant to the derivation of assessable income, it would be deductible in full. According to Parsons, this outcome was available under the general deduction section of the ITAA36, even without the addition of the phrase 'to the extent to which'.²⁵

It is the second kind of apportionable outgoing identified in *Ronpibon Tin*, where the inconsistency between the approach of the courts and tribunals considered in this article and the approach of Parsons potentially arises. This outgoing concerns a single outlay which serves two objects (the gaining of assessable income and some other cause) indifferently. For this category, the High Court provides guidance that the

²³ (1949) 78 CLR 47, 59.

²⁴ Mobile telephone costs were considered in *Pitcher v DFC of T* 98 ATC 2190.

²⁵ Parsons, above n 1, 9.4.

apportionment should be based on a 'fair and reasonable assessment of the extent of the relation of the outlay to assessable income'²⁶.

The apportionment process applied in the second scenario is a 'rough and ready process', whereby different apportionment methods producing different results may be equally acceptable.²⁷ It essentially involves a factual determination to be conducted by the tribunal of fact, with the tribunal having significant flexibility in achieving its overriding objective, namely, the application of an apportionment that is 'just' or 'fair and reasonable'.

What is Parsons' position on this process? Apart from highlighting the underlying administrative difficulty, he recommends that the process should not be applied in such a way that a 'doubt about relevance' of the expense might be raised. Using the example of directors fees (as did the High Court in *Ronpibon*), he notes that no doubt about relevance arises because 'it is none the less possible to contemplate a separate payment being made to directors for work that is relevant to the derivation of income by the company and a separate payment for work that is not'.²⁸ Similarly, at [8.51] he argues that 'the approach to apportionment of an expense suggested in [9.11] below is that it is proper only when a separate outgoing could have been made to serve the purpose that would give the expense relevance'.

From Parsons' perspective, apportionment in the second scenario is only appropriate when, although the expense serves two objects indifferently (and is incapable of 'arithmetical or rateable division'), the expense could have been split into separate relevant and non-relevant outgoings, with a full deduction being granted for the relevant outgoing. Parsons therefore appears to apply a hypothetical construct to the application of apportionment under the second scenario, which seeks to achieve an outcome which is the same as that achieved by apportionment in the first scenario. There is no 'partial' relevance for deductions according to Parsons.

In many cases considered for the purposes of this article, it appears that, in the name of *Ronpibon Tin*, the tribunal is willing to apportion the expense and grant a minor deduction even where derivation of a private benefit constitutes the dominant purpose of the expense.²⁹ In doing so, the tribunal is potentially applying a concept of 'partial' relevance, which raises doubt about the relevance of the overall expense.

²⁶ *Ronpibon Tin NL v FCT* (1949) 78 CLR 47, 59-60.

²⁷ *Handley v FC of T* (1981) 148 CLR 182, 193 (Stephen J).

²⁸ Parsons, above n 1, 9.12.

²⁹ See for instance *Re Peter Lenten and Commissioner of Taxation*, AAT unreported judgment, [2008], BC200802369; *Case S12 85 ATC* 165; *Case U5 87 ATC* 124.

How do we deal with this problem? A possible answer is to follow the Parsons approach and apply a dominant purpose test to settle both the relevance and apportionment issues.³⁰ Under this approach, where the purpose of deriving assessable income is dominant, there should be no apportionment and the entire expense should be deductible. Alternatively, where generation of a private benefit dominates, there should be no apportionment and the entire expense should be held to be non-deductible. The simplicity of such an approach cuts through a significant part of the administrative difficulty underlying the apportionment process as currently applied to dual-purpose expenses. An initial evaluation is conducted below under the heading 'Apportionment Cases' by analysing the approach taken by the AAT and the Courts to the question of apportionment in the context of the following categories of dual-purpose expenses:³¹

1. Home office/study;
2. Clothing;
3. Telephone;
4. Hotel and other accommodation (application of the 'marginal cost' approach);

³⁰ Parsons, above n1, 8.85.

³¹ The categories of expense considered were derived from extensive case and ruling research on the question of apportionment of partially private expenses. While the discussion on the clothing category is based on cases involving somewhat unique fact circumstances, these cases nevertheless provide a useful insight into how the apportionment process is applied by the courts and the AAT. Of the remaining categories, the discussion on home office, telephone and recreational expenses would be highly relevant to tax practitioners. As the ATO audit processes have noted that tax returns which claim deductions in these categories often fail to provide a 'reasonable' basis for the claimed deductible percentage of relevant expenditure. See, eg, 'Why tax agent returns are returned' (1997) 31 *Taxation in Australia* 7. Interest expenses, as considered in *Fletcher v FCT* 173 CLR 1 and in *Ure v FCT* (1981) 50 FLR 219, are not given further attention in this section of the article, as they do not come within the particular type of dual-purpose expense which is the focus of this article. These interest expense cases concern the application of an apportionment process in a scenario where the interest outgoing leads to the derivation of both assessable and exempt income or leads to the obtaining of a tax deduction, so that the amount of assessable income generated is less than the amount of the outgoings. This is different to the dual-purpose expense types considered in this article where the expense can be linked to both the derivation of assessable income and to the generation of a private benefit (such as the satisfaction of a personal consumption preference).

5. Professional vs recreational expenses; and
6. Self-education expenses – taxation ruling TR 98/9.

Apportionment cases

*Home office/study*³²

The typical fact scenario concerns a taxpayer who is required to carry out work duties through a home office or study. It is not merely for the convenience of the taxpayer that the home office or study is used for work purposes. As work requirements impose the use of the home office or study, the question arises which deductions the taxpayer can claim in respect of various costs incurred on the home such as rent or mortgage interest, insurance, rates, heating, cooling and lighting.

These payments appear to constitute dual-purpose outgoings as they are incurred in generating assessable income (through the use of the home office for work purposes) as well as in respect of personal consumption (the provision of domestic accommodation). Despite the fact that personal consumption clearly constitutes the dominant purpose of the relevant payment, in *Swinford, Lyons* and *Case U65*, the payment was apportioned and a deduction was allowed for part of the expense. Deductions of significantly less than 50% of the total expense were allowed in each instance.

An approach that tests the overall relevance of the expense does not really apply in these cases. As noted by Parsons, there is a distinction between a home that is 'business premises' and a home used for 'business purposes'.³³ As work requirements impose the use of the home office or study, the position of the taxpayer is similar to that of a doctor who maintains a surgery at home. Therefore, the surgery constitutes a place of business rather than part of the home. The work done out of the home office/study is beyond any notion of domestic use of the premises and 'shelter expenses will be deductible to the extent that they are fairly attributable to the area of the home used, and the time devoted to that work'. The cases provide that the taxpayer should be regarded as having made separate payments of mortgage interest (or rent), insurance and rates in connection with the home office/study which should be treated as fully relevant and deductible.³⁴ We apply the *Ronpibon Tin*

³² *Handley v FC of T* (1980) 42 FLR 125; *Swinford v FC of T* [1984] 3 NSWLR 118; *Lyons v FC of T* 99 ATC 2258; *Case U65* 87 ATC 415; *Re Ovens v C of T*, AAT unreported judgment, [2009], BC200901514.

³³ Parsons, above n 1, [8.35].

³⁴ See for instance *Case U65* 87 ATC 415, 422.

apportionment process in order to identify, as far as reasonably possible, these separate payments.

The underlying apportionment principle applied in these cases involves identifying how much extra is being paid by the taxpayer because the taxpayer is required to carry out work duties through a home office/study and then allowing a deduction for that extra amount.³⁵ This involves a calculation of the proportion of floor space attributable to the income generation purpose and a calculation of the time attributable to income generation as a proportion of the total time in which the relevant home office area is used for both income generation and domestic purposes. The total deduction which the taxpayer can claim for various residence costs such as mortgage interest (or rent), rates and insurance is a factor of both these calculations.³⁶

What of the cost of heating, cooling and lighting? It is interesting to note that the Commissioner concedes a deduction for such costs where professional work is conducted out of a home office and where there is a nexus between that work and assessable income generation. The taxpayer is entitled to deduct the difference between the total cost paid for heating, cooling and lighting and the cost that would have been paid for these items had the taxpayer not worked from home.³⁷ This is not an easy figure to calculate.³⁸

Clothing

In most cases, expenditure on conventional clothing will not be deductible. The federal court case of *Edwards* (1993) 119 ALR 375 and taxation ruling TR 94/22³⁹ (which was issued in response to *Edwards*), however, confirm that there may be some instances where there is a direct nexus between conventional clothing expenditure and the derivation of assessable income. These instances require an apportionment of the expenditure and the granting of a deduction of part of the expense; for example,

³⁵ See for instance *Lyons v FC of T* 99 ATC 2258, 2259.

³⁶ *Handley v FC of T* (1980) 42 FLR 125, 127 (Yeldham J).

³⁷ This concession was made by the Commissioner in *Lyons v FC of T* 99 ATC 2258; the suggested deduction is also referred to in TR 93/30, [23]; deductions for home office running costs were allowed by the AAT in *Re Ovens v C of T*, AAT unreported judgment, [2009], BC200901514.

³⁸ In TR 93/30, [24] the Commissioner provides a formula for calculating this figure for an appliance: (a) x (b) x (c) where (a) is the cost per unit of power used, (b) is the average units used per hour and (c) is the total annual hours used for income producing purposes.

³⁹ Australian Taxation Office, *Income Tax: Implications of the Edwards Case for the Deductibility of Expenditure on Conventional Clothing by Employees*, TR 1994/22, 23 June 1994.

where the nature of the taxpayer's employment is such that the taxpayer is regularly required to attend public engagements in formal attire. Other examples are given in TR 94/22.⁴⁰

Neither the case of *Edwards* nor TR 94/22 make mention that the relevance of conventional clothing expenses is to be assessed according to a dominant purpose test. The dominant purpose of the clothing acquired does not have to be work related in order for the deduction to be granted. As long as there is a direct nexus between the expense and the derivation of assessable income, the expense can be apportioned and a deduction granted for part of the expense.⁴¹

According to TR 94/22 (para 10), a reasonable estimate of work use relative to private use of the clothing should be applied. The case of *Edwards* confirms, however, that it is impractical to apply this approach to a large volume of clothing. In that case, the court applied a principle which is similar to that referred to above in respect of the home office/study. The court compared overall clothing expenses incurred during a period that the taxpayer was not subject to those demands with expenses which were incurred during a period in which the work demands applied.⁴²

Again, the question arises – when looking at the whole expense; do we have a relevance problem if we apportion the expense and grant a deduction for part of the expense? The clothing scenarios considered in *Edwards* and TR 94/22 could potentially be viewed as being similar in their outcome to the home office/study scenario considered in *Swinford*, *Lyons* and *Case U65*. The use of the clothing is specifically imposed by work requirements. It could be argued that the clothing, although conventional, is 'work clothing'. Should we treat this clothing as being beyond any personal use? It is difficult to contemplate separate deductible payments being made for the use of conventional clothing for work requirements when the same clothing is predominantly used for personal purposes. From a policy perspective, it would be simpler to apply a dominant purpose test to the clothing and allow a deduction for the entire expense if the conventional clothing is predominantly used for work purposes.

⁴⁰ Refer to TR 94/22, [27]-[31].

⁴¹ In *Edwards*, Gummow J applied the essential character test in determining that a sufficient nexus existed between the clothing expenses and the production of assessable income (119 ALR 375, 380-383). Gummow J's decision was affirmed on appeal by the full Federal Court (49 FCR 318).

⁴² *FC of T v Edwards* (1993) 119 ALR 375, 383 (Gummow J). Gummow J in fact approved the apportionment basis which had been applied by the AAT (93 ATC 359).

Clothing expenses were also considered in the Federal Court case of *Morris v Commissioner of Taxation*.⁴³ In his judgment, Goldberg J acknowledges that he is dealing with dual-purpose expenses. Having decided that the sun-protection expenses under consideration were relevant to the derivation of assessable income, Goldberg J determined that the expenses should be apportioned to reflect the mixed work use/personal use. In his judgment Goldberg J makes comments such as, 'I am satisfied there is a real connection between Ms Boydell's income-producing activities and **part** of her expenditure of \$30 in respect of her acquisition of sunglasses' (at [131]); 'I am satisfied therefore that a **proportion** of Ms Boydell's expenditure on the sunglasses is incidental and relevant to her occupation as a teacher of maritime studies' (at [132]); 'The eighth applicant, Stephen Douglas Fennell. I am satisfied that a **proportion** of the expenditure of \$25 claimed as a deduction in respect of his purchase of sunglasses is incidental and relevant to his occupation as a district operator with Energy Australia' (at [138]). In each instance, given the indissectibility of the outlay, the question arises - what of the relevance of the total expense? The application of a dominant purpose approach, as recommended by *Fletcher* and *Parsons*, helps to resolve this problem by treating the entire expense as relevant and deductible where the purpose of deriving assessable income dominates.

Goldberg J's decision expressly reflects the 'partial relevance' problem highlighted by *Parsons*. Whilst the Commissioner challenged the expenditures considered in the case on the basis that they were not incidental or relevant to the production of assessable income (as they were essentially of a private nature), he did not contest the taxpayers' work use/personal use estimates. The taxpayers had claimed that the expenses were relevant and fully deductible, whilst the Commissioner claimed that the expenses were not deductible at all (at [72] to [77]). No one claimed that the expenses should be apportioned if found to be relevant. It was Goldberg J who imposed this outcome on the understanding that deductibility is a two-stage process, whereby the question of relevance is first considered (by applying tests such as the 'essential character' test) and if the relevance threshold is satisfied, an apportionment of the expense then follows. Accordingly, Goldberg J applied the taxpayers' work-use/personal use estimates when directing how the deductions should be apportioned and calculated upon reconsideration by the Commissioner.

*Telephone*⁴⁴

As detailed records are kept of telephone calls (both for landline phones and mobile phones), it is not too difficult a process to identify which calls are work-related and

⁴³ [2002] FCA 616.

⁴⁴ *Pitcher v DFC of T* 98 ATC 2190; *Case R2 84* ATC 106.

which calls are private and to thereby calculate the extent to which a phone has been used in gaining assessable income.

What about the cost of a mobile phone handset or the rental of a land line which is used for both work-related and private purposes? In Board of Review *Case R2* it was suggested by Member Beck that if you need the phone to carry on business, you can deduct the entire cost.⁴⁵

Member Beck did not specifically apply a dominant purpose test in finding that the relevance threshold was satisfied and that the handset cost or line rental should be deductible in full. The mere existence of an income producing purpose appears to have been sufficient for Member Beck to find that the whole amount was deductible.⁴⁶

Hotel and other accommodation (application of the 'marginal cost' approach?)⁴⁷

The typical fact scenario concerns a taxpayer who travels overseas for work-related purposes (such as attending a conference or conducting research) and is accompanied by his or her spouse with the intention that the overseas travel also be used as a holiday. A question arises as to the deduction which can be claimed by the taxpayer for hotel or other accommodation which the taxpayer shares with his or her spouse during the time spent abroad.

Taxpayers under this scenario often apply an 'economic model' in calculating the deduction. In the case of hotel accommodation, the taxpayer claims a deduction for the entire cost of the accommodation, less the additional charge levied by the hotel for accommodating a second person in the room. For other accommodation, the taxpayer argues that, as the cost of the accommodation is fixed regardless of whether the apartment is used by one or more persons, the taxpayer should be entitled to claim the entire cost as a deduction. Both these claims are rejected by the ATO which considers that actual use of the accommodation is shared between the taxpayer and his or her spouse. Consequently, the ATO apportions the accommodation deduction on a 50/50 basis.⁴⁸

The taxpayer's claims under this scenario reflect a 'marginal cost' approach. Under this approach, the objective is to identify the marginal cost increase incurred as a result of the spouse's presence. Hotel accommodation is readily identifiable and

⁴⁵ 84 ATC 106, 118.

⁴⁶ Ibid.

⁴⁷ *Case V15 88 ATC 177; Case R2 84 ATC 106; Case S80 85 ATC 589.*

⁴⁸ *Case V15 88 ATC 177, 179.*

corresponds to the additional charge imposed by the hotel for dual occupancy. In the case of other accommodation (such as a residential apartment), the marginal cost corresponds to zero as there is no cost increase occasioned by the spouse's presence.⁴⁹

Although the marginal cost approach was approved by the Board of Review in *Case R2*, it was rejected in *Case V15* and *Case S80*. A number of criticisms of this approach can be made. First, in the case of a taxpayer and spouse using accommodation, both occupants share equally in the facilities and there is no logical basis for determining which of the occupants should bear only the marginal cost.⁵⁰ Second, the marginal cost approach involves a claim for a deduction which relies on a hypothetical situation, namely, that the taxpayer incurred accommodation costs just for himself or herself.⁵¹ However, the accommodation costs are incurred for the taxpayer and his or her spouse. *FCT v Western Suburbs Cinemas* (1952) 86 CLR 102 confirms that a notional deduction is not permissible.⁵²

The underlying principle to be extracted from the cases concerning accommodation is that the accommodation expense should be apportioned on the basis of the taxpayer's share of the actual use made of the apartment and not on the basis of a marginal cost approach.

The scenario considered in this section of the discussion raises an interesting issue regarding the threshold question of relevance. If a dominant purpose test is applied, it is clear that the threshold will not be satisfied. Given that the taxpayer and spouse share equally in the use of the accommodation, there is no basis to argue that the dominant purpose of the expense is the gaining of assessable income. The expense serves two purposes equally – the taxpayer's work-related purpose and the spouse's holiday purpose. Nevertheless, applying *Ronpibon Tin*, the tribunal and the Commissioner are willing to apportion the expense and grant a deduction on a 50/50 basis.

Professional vs recreational expenses⁵³

This scenario concerns professional expenses which also have an incidental recreational benefit. Examples include overseas travel to various historical sites by history teachers and the purchase of magazines and newspapers by teachers from

⁴⁹ *Case V15* 88 ATC 177, 184.

⁵⁰ This criticism was made in *Case R2* by Member Beck, 84 ATC 106, 119.

⁵¹ *Case S80* 85 ATC 589, 594 (Member Stevens) and 596 (Member McCarthy).

⁵² This argument is also supported by Parsons, above n 1, 9.12.

⁵³ *Re Peter Lenten and Commissioner of Taxation* [2008] BC200802369; *Case S12* 85 ATC 165; *Case U5* 87 ATC 124.

which classroom teaching material is extracted. The tribunal decisions in this category confirm that the expense must be apportioned and the deduction claimed must be reduced to take into account the incidental recreational benefit. No guidance is provided to taxpayers as to how that incidental recreational benefit might be gauged and calculated. The only underlying principle which might be extracted is that for newspapers and magazines, the tribunal regards the recreational benefit as being overwhelmingly dominant with only a minor deduction being granted.⁵⁴ Once again, it appears that the tribunal proceeds to apportionment without considering the relevance of the overall expense.

Self-education expenses – taxation ruling TR 98/9

For the purposes of this article, it is the ruling's comments on the apportionment of self-education expenses which serve both an income-earning purpose and a private purpose which are of interest. According to the ruling, if the income-earning purpose is merely incidental to the main private purpose, only the expenses which relate directly to the former purpose are allowable.⁵⁵ An example of this is discussed at paragraphs 65 and 69. The example given clearly treats these expenses as coming within the first kind of apportionable outgoing referred to in *Ronpibon Tin*. They can be dissected from those expenses relating to the taxpayer's private holiday and, as they can be clearly traced to the derivation of assessable income, a deduction would be allowable.

The ruling also states that, if the private purpose is merely incidental to the main income-earning purpose, apportionment is not appropriate.⁵⁶ An example is discussed at paragraphs 67 and 68. The example given clearly treats the relevant expense as potentially coming within the second kind of apportionable outgoing referred to in *Ronpibon*. The ruling acknowledges that the incidental private purpose does not affect the characterisation of the expense as wholly incurred in gaining assessable income and it is for this reason that it is not necessary to apportion.

What is the position when a study tour or work-related conference or seminar is undertaken equally for income-earning purposes and private purposes? In this instance, can the expense be properly regarded as having been 'wholly incurred in gaining assessable income'? The ruling is silent on this issue. It merely acknowledges

⁵⁴ *Case S 12 85* ATC 165, 169.

⁵⁵ TR 98/9 [17].

⁵⁶ *Ibid.*

that where there is equality of purpose, it would be appropriate to apportion the expense equally between the purposes.⁵⁷

Conclusions

The analysis conducted in this article has identified some clear principles that should be applied to the task of deducting dual-purpose expenses which can be linked both to the derivation of assessable income and to the generation of a private benefit.

Firstly, this article argues that deductibility is a two-stage enquiry, involving questions of relevance and apportionment where apportionment usually follows relevance. The task of characterising outgoings is separate to that of apportioning them. The question of relevance is the threshold issue which must be first determined by assessing the expense as a whole.

Parsons disagrees with the position that apportionment usually follows relevance. Depending on the test used to determine relevance, apportionment may not follow relevance. If in determining relevance we apply a 'dominant purpose' test, then it results in an 'all or nothing' situation and there is no need to apportion. However, if we apply the test from *Studdert* (whereby the relevance threshold is regarded as being satisfied by the mere co-existence of an income producing purpose with a non-income producing purpose, regardless of whether the income producing purpose is dominant or not) then the analysis conducted in this article has shown that apportionment of the expense should follow if, as directed by section 8-1 and *Ronpibon Tin*, we are to allow a deduction which will separate out that part of the expense that serves the non-income producing cause.⁵⁸ As mentioned above, however, Hill J was not called upon to expressly consider the relationship between relevance and apportionment in *Studdert*. Parsons' analysis would also encourage us to ask – does the latter approach potentially constitute an exercise in 'partial relevance'?

We are then faced with the problem of how to apportion. *Ronpibon Tin* confirms that if the expense has distinct and severable parts then the apportionment process is a straightforward exercise. Where the expense, however, is in the form of a single outlay which serves two purposes indifferently, apportionment is based on a fair and reasonable assessment of the extent of the relation of the outlay to assessable income.

Parsons points out that the latter process constitutes an exercise in administrative difficulty which potentially expresses doubt about the relevance of an overall

⁵⁷ Ibid [66].

⁵⁸ See for instance *Morris v Commissioner of Taxation* [2002] FCA 616 [79].

expense. As shown in this article, this conclusion appears to be borne out in a number of case and tribunal apportionment decisions. In order to avoid such an outcome, Parsons suggests an interpretation of *Ronpibon Tin* which breaks down an overall dual-purpose expense into either actual or hypothetical/notional outgoings which are in themselves relevant and deductible. There are, however, difficulties with this interpretation. *Western Suburbs Cinemas* confirms that a hypothetical/notional deduction is not permissible. Accordingly, Parsons' analysis would encourage us to consider whether it would be preferable to apply the dominant purpose test with no need to apportion.

Applying these principles to the various categories of dual-purpose outgoings considered in this article, separate deductible outgoings could potentially be identified for the home office/study, hotel/accommodation and self-education scenarios. It is difficult to contemplate such outgoings for the clothing, telephone handset/line rental and professional/recreational scenarios. For these scenarios, the indissectibility of the outlay and the predominance of personal use make it difficult to contemplate an apportionment being made to somehow identify potential separate payments which are in themselves relevant and deductible. For such categories of dual-purpose expense, this article has argued that it may be simpler to deny the deduction entirely and not to apportion through the application of a 'dominant purpose' approach.

These are issues requiring further consideration and evaluation, perhaps even a reconsideration of *Ronpibon Tin* and *Studdert* by the High Court. In conducting this further evaluation, it is important to keep in mind that the problem raised by the apportionment process does not only concern the underlying uncertainty in the law and the consequential administrative difficulty for taxpayers. In addition, the 'partial relevance' problem which the apportionment process potentially creates can have negative implications for the tax base. At one end, as occurred in *Studdert* and in *Case R2*, it seems that any amount of income producing purpose will suffice to make the whole amount deductible. At the other end, if we allow taxpayers to continually claim minor deductions for dual-purpose expenses that serve a predominantly private benefit and which do not pass a dominant-purpose relevance threshold, then the total cumulative effect of such deductions on the Revenue is likely to be significant over the longer term.

These are issues requiring further consideration and evaluation, perhaps even a reconsideration of *Ronpibon Tin* by the High Court. In conducting this further evaluation, it is important to keep in mind why Parsons appears to have been so keen to avoid the 'partial relevance' problem which the apportionment process potentially creates. Clearly, given that 'some' relevance can be claimed with 'impeccable logic',

in regard to almost any expense imaginable, the concept of partial relevance can have quite negative implications for the tax base.⁵⁹

⁵⁹ Parsons, above n 1, [5.51].